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The Games They Will Play: Tax Games, Roadblocks, and Glitches Under the 2017 Tax Legislation

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Article

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Rebecca Kysar, Darien Shanske, Reuven Avi-
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Beyond the listed authors, this article reflects insights from many other tax scholars, practitioners, and analysts, as acknowledged in the footnotes to the text. All errors are our own. Copyright © 2019 by David Kamin, David Gamage, Ari Glogower, Rebecca Kysar, Darien Shanske, Reuven Avi-Yonah, Lily Batchelder, J. Clifton Fleming, Daniel Hemel, Mitchell Kane, David Miller, Daniel Shaviro, and Manoj Viswanathan.

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INTRODUCTION

In the final months of 2017, Congress enacted the most expansive tax legislation in decades,¹ with sweeping changes to the rules for taxing individuals and business, the deductibility of state and local taxes, and the international tax regime. The tax legislation² was drafted and passed quickly through a rushed

1. See H.R. 1, 115th Cong. (2017) (enacted); Samuel A. Donaldson, *Understanding the Tax Cuts and Jobs Act 1* (Ga. State Univ. Coll. of Law, Legal Studies Research Paper No. 2018-07, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3096078 (“[This] represents the most dramatic change to the Internal Revenue Code since passage of the Tax Reform Act of 1986. . . . Whereas the Tax Reform Act of 1986 was the product of years of bipartisan negotiation, the Tax Cuts and Jobs Act was the product of a deeply partisan and largely closed-door process.”).

For further discussion of extensive negotiations and deliberations resulting in the Tax Reform of 1986, see, for example, JEFFREY H. BIRNBAUM & ALAN S. MURRAY, *SHOWDOWN AT GUCCI GULCH: LAWMAKERS, LOBBYISTS, AND THE UNLIKELY TRIUMPH OF TAX REFORM* (1987); Daniel Shaviro, *Beyond Public Choice and Public Interest: A Study of the Legislative Process as Illustrated by Tax Legislation in the 1980s*, 139 U. PA. L. REV. 1 (1990).

2. Throughout this Article, we refer to the new legislation as the “2017 tax legislation,” or as just the “tax legislation.” The full name of the legislation had been the “Tax Cuts and Jobs Act” (TCJA), and many commentators continue to refer to the legislation by this name. However, the Senate parliamentarian ruled that this name was non-germane, resulting in the name being removed from the legislation. Press Release, U.S. Senate Comm. on the Budget, *Parliamentarian Determines Three Provisions in Republican Tax Bill Are Impermissible* (Dec. 19, 2017), <https://www.budget.senate.gov/ranking-member/newsroom/press/parliamentarian-determines-three-provisions-in-republican-tax-bill-are-impermissible>. For further explanation, see Daniel Shaviro, *The*

process,³ denying legislators and the public sufficient time to analyze the provisions of the legislation—many of which are highly complex.

This Article is an effort to supply the analysis and deliberation that should have accompanied the bill's passage, and describes key problem areas in the tax legislation.⁴ These problems are organized in three general categories:

Tax Games. Many of the new changes fundamentally undermine the integrity of the tax code and draw new and arbitrary lines dividing the tax system into winners and losers. As a result, well-advised taxpayers will have new opportunities to game⁵ the rules and avoid taxes through strategic planning, while the IRS will have a hard time preventing abuse. Similarly, the new rules limiting the deductions for state and local taxes will invite states to adjust their forms of revenue collection to game the new rules, as some states are already doing.⁶ Official projections expect the

Act with No Name, START MAKING SENSE (Dec. 21, 2017), <http://danshaviro.blogspot.com/2017/12/the-act-with-no-name.html>.

3. Edward Kleinbard, *Senators Picked Americans' Pockets Via Degraded Tax Policy Process*, THE HILL (Dec. 4, 2017), <https://thehill.com/opinion/finance/363096-senators-picked-americans-pockets-via-degraded-tax-process> ("This time, the process has been so rushed and so secret that the Senate early Saturday morning voted on legislation that in part comprised handwritten amendments stuck into the bill But the problems run much deeper than the break-neck schedule.").

4. This Article does not aim to offer a comprehensive list of problems with the new legislation. Rather, the Article identifies the most significant problem areas, and describes the most critical considerations that were not adequately addressed by Congress at the time of the tax legislation's passage. Similarly, this Article is not intended as an indictment of every aspect of the tax legislation, which also included some beneficial updates to the Tax Code, such as the new limitations on the deductibility of business entertainment expenses or reducing the corporate tax code's preference for debt financing, even if that provision may face technical challenges. *See also* Reuven S. Avi-Yonah, *How Terrible Is the New Tax Law? Reflections on TRA17* (Univ. of Mich. Pub. Law Research Paper No. 586, Univ. of Mich. Law & Econ. Research Paper No. 18-002, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3095830.

5. Following earlier work by David Gamage, we use the terms "tax games" and "tax gaming" to refer to both legal tax avoidance and illegal tax evasion, as well as to the large gray area of tax planning transactions that are neither clearly legal nor clearly illegal. *See* David Gamage, *How Should Governments Promote Distributive Justice?: A Framework for Analyzing the Optimal Choice of Tax Instruments*, 68 TAX L. REV. 1, 5 (2014). That said, our focus in this Article is mostly on legal and borderline-legal forms of tax gaming.

6. *See, e.g.*, Leonard E. Burman & Frank Sammartino, *State Responses to the TCJA's SALT Deduction Limit May Be Costly and Favor High-Income Residents*, TAXVOX: ST. & LOCAL ISSUES (Jan. 30, 2018), <http://www.taxpolicycenter.org/taxvox/state-responses-tcjassalt-deduction-limit-may-be-costly-and-favor-high-income-residents>.

tax legislation to cost more than \$1 trillion⁷ while primarily benefiting the wealthiest taxpayers.⁸ Taking into account the gaming opportunities described in this Article, we expect that the actual distributional and revenue costs of the legislation will likely significantly exceed these projections.⁹ As this Article describes, there are no simple fixes for many of the gaming opportunities invited by the tax legislation.

Roadblocks. Other changes in the tax legislation may interfere with important non-tax policies and encounter legal roadblocks. For example, critical elements of the changes to the international tax system may cause the United States to violate international trade law.¹⁰

Glitches. Finally, some problems with the tax legislation arise from mistakes or ambiguity in drafting that could lead to uncertainty and haphazard increases or decreases in taxes. Such problems are the most amenable to legislative or regulatory fixes, and do not seriously threaten the structure of the tax system. These problems do evidence, however, Congress's haste and the lack of care in drafting and passing the tax legislation. Taken together, the problems demonstrate how a rushed and secretive process resulted in deeply flawed legislation. Tax law is too complex and interconnected to be reformed without transparency and public deliberation. By documenting the gaming opportunities, roadblocks, and glitches in the legislation, we hope that this Article will also serve as a cautionary note for future attempts at tax reform—warning legislators about the dangers of drafting tax law in the shadows, and the importance of a responsible and responsive process when making changes that affect every American taxpayer and every sector of the economy.

7. STAFF OF JOINT COMM. ON TAXATION, 115TH CONG., MACROECONOMIC ANALYSIS OF THE CONFERENCE AGREEMENT FOR H.R. 1, THE "TAX CUTS AND JOBS ACT" 9 tbl.1 (Comm. Print CMP-2017-JTX-0031).

8. See TAX POLICY CTR. STAFF, DISTRIBUTIONAL ANALYSIS OF THE CONFERENCE AGREEMENT FOR THE TAX CUTS AND JOBS ACT 1 (2017) <https://www.taxpolicycenter.org/publications/distributional-analysis-conference-agreement-tax-cuts-and-jobs-act/full> (finding that the largest cuts as shares of income would go to taxpayers in the 95th to 99th percentiles).

9. The purpose of this Article is not to argue whether individuals or state entities *should* engage in these gaming opportunities or not, but rather to identify the gaming opportunities and their expected effects. For an argument that states should make adjustments to their revenue-collection methods in response to the tax legislation, see Daniel Hemel, *Why States Should Seek to Offset the Effects of the SALT Rollback*, MEDIUM: WHATEVER SOURCE DERIVED (Feb. 2, 2018), <https://medium.com/whatever-source-derived/why-states-should-seek-to-offset-the-effects-of-the-salt-rollback-8a53fc23cbeb>.

10. See *infra* Part IV.B.1.

Before long, policymakers will inevitably be tasked with enacting further changes to the tax law in order to undo the legislation's harmful effects on the fiscal system.¹¹ This Article also describes reform options for policymakers, in order to begin the process of restoring the integrity of the tax system and to initiate scholarly conversation on what comes next.

The remainder of this Article proceeds as follows. Part I analyzes opportunities for taxpayers to use corporations as tax shelters under the tax legislation. By dramatically reducing the corporate tax rate without carefully considering the interactions between the corporate and individual income taxes, the tax legislation will enable many taxpayers to use corporations as tax-sheltered savings vehicles through a variety of strategies. We explain how the use of corporations as tax shelters can result in both investment and labor income being taxed at only the preferential twenty-one percent corporate rate, rather than the higher individual-level tax rates which could exceed 40%.¹²

Part II analyzes problems related to the new tax deduction provided for certain pass-through businesses. The complex rules governing this new deduction will invite gaming opportunities because there is no particular logic as to who clearly fits into the preferred categories. As a result, taxpayers will be incentivized to engage in aggressive and socially costly tax gaming to fall within the haphazardly drawn lines. This Part also discusses proposed regulations issued by Treasury in August 2018¹³ to address particular gaming strategies arising from the legislation, and how these regulations, if finalized, would still preserve opportunities for abuse.

Part III describes how state and local governments might respond to the new cap on the federal deduction for state and local tax (SALT) payments. We explain how the structure of the new SALT deduction cap will incentivize state and local governments to restructure their forms of revenue collection so as to circumvent the cap. Such responses by state and local governments could well undercut one of the largest revenue raisers in

11. Furthermore, many important features of the tax legislation were made temporary, virtually guaranteeing further significant legislation within the next decade. See TAX FOUND. STAFF, PRELIMINARY DETAILS AND ANALYSIS OF THE TAX CUTS AND JOBS ACT 10 (2017) (noting the "temporary nature of the majority of the individual income tax changes").

12. See *infra* Part I.

13. Qualified Business Income Deduction, Prop. Treas. Reg. §§ 1.199A-1.643, 83 Fed. Reg. 40,884 (Aug. 16, 2018) (to be codified at 26 C.F.R. pt. 1).

the entire tax legislation, in addition to creating legal uncertainty and other social harms. This Part similarly discusses proposed regulations issued by Treasury that would address one possible response by state and local governments to the SALT deduction cap,¹⁴ as well as new pressures that would result from the regulatory approach.

Part IV analyzes international games, roadblocks, and glitches. We explain how the tax legislation's complex new rules intended to exempt foreign income of domestic corporations from U.S. taxation present a variety of tax gaming opportunities. For instance, one provision would encourage sales of products abroad, only for those products to be sold right back into the United States.¹⁵ Furthermore, several aspects of the new rules are likely to raise issues with both World Trade Organization rules for international trade and our network of bilateral tax treaties.¹⁶ Some of these rules also create perverse economic incentives, like advantaging foreign over domestic manufacturers. Part V describes some significant additional games and glitches arising from the legislation.

I. USING CORPORATIONS AS TAX SHELTERS

Perhaps the most significant change brought by the 2017 tax legislation was the reduction of the highest statutory corporate income tax rate from 35% to 21% percent.¹⁷ In this Part, we explain how this change will allow taxpayers to avoid the individual income tax by using a corporation as a tax-sheltered savings vehicle. In effect, taxpayers will be able to transform individual income—that would otherwise be taxed at the individual rates which could exceed 40%—into corporate income that is taxed at the much lower 21% rate.¹⁸

The basic advantage to investing or earning income through a corporation is that the income is not immediately taxed to the individual taxpayer. The cost of earning income through a corporation, however, is the “double tax” on the income, both to the

14. Contributions in Exchange for State or Local Tax Credits, Prop. Treas. Reg. § 1.164(b)(6), 83 Fed. Reg. 43,563, 43,569 (Aug. 27, 2018) (to be codified at 26 C.F.R. pt. 1).

15. See *infra* Part IV.

16. See *infra* Part IV.

17. I.R.C. § 11(b) (2017) (stating a top rate of 35%); *id.* § 11(b) (stating a top rate of 21%); H.R. 1, 115th Cong. § 13,001 (2017) (enacted).

18. I.R.C. § 1(a)–(e).

corporation (when the income is earned)¹⁹ and to the individual taxpayer (upon a distribution or sale of their corporate interest).²⁰ Nevertheless, with a sufficiently low corporate tax rate, taxpayers can still benefit from earning income through a corporation, even in light of this potential double tax. In many cases, taxpayers will be able to entirely avoid the second individual layer of tax, and therefore escape double taxation entirely.

Section A describes the general principles behind these planning opportunities, and Section B illustrates the specific games taxpayers can play in order to achieve these results. Finally, Section C describes opportunities for reform in order to prevent these games.

A. THE TWO-STEP GAME FOR SHELTERING INCOME THROUGH A CORPORATION

Tax gaming opportunities based on using a corporation²¹ as a tax shelter generally involve two steps. The first step is for the taxpayer to earn income through the corporation, rather than as an individual. The second step is for the taxpayer to defer or entirely avoid the second individual layer of tax upon a distribution of the earnings from the corporation or from sale of the corporate stock.

19. *Id.* § 11(a).

20. A distribution or a sale of the corporate interest will be taxable to the individual as, respectively, a dividend or capital gain. *Id.* § 1(h).

21. For purposes of this discussion, references to a “corporation” refer to a “C corporation” subject to the entity-level corporate tax under I.R.C. §11 (specifically, a corporation as defined in section 7701(a)(3) of the Internal Revenue Code and section 301.7701-2(b) of the Treasury Regulations, which does not elect to be taxed as an “S corporation” under section 1362 of the Internal Revenue Code).

1. Why the Two-Steps: A Game of Rates

The two-steps are necessary for a taxpayer to generate substantial tax savings by earning income through a corporation and avoiding the individual layer of tax. There would be relatively little tax savings if a taxpayer earned income through a corporation and then immediately distributed the earnings, triggering the second individual layer tax. Importantly though, even if that second individual layer of tax *is* immediately triggered and paid, a taxpayer can *still* enjoy a slightly lower total tax rate on their income under the new tax legislation—unlike under prior law. As a result, earning income through a corporation is a win-win for the taxpayer: If the second layer of tax is immediately paid, the taxpayer still enjoys small potential tax savings; and if the second layer of tax is deferred or eliminated, the tax savings become much larger.

The Benefit of Earning Income Through a Corporation		
	Pre-2017 Tax Legislation Rates	Post-2017 Tax Legislation Rates
A. Top "Ordinary" Individual Income Tax Rate	44.6%	40.8%
B. Top Corporate Tax Rate	35.0%	21.0%
C. Top Dividends/Capital Gains Rate (Second Level of Tax)	25.0%	23.8%
D. Combined Top Rate on Corporate Income <i>If</i> Income Immediately Distributed ($B + (C \times (1 - B))$)	51.3%	39.8%
Source: Authors' calculations. The rates here combine individual income taxes, net investment income taxes, and the effect of the Pease limitation on itemized deductions.		

The table above shows the relative rates affecting income earned by an individual (and taxed at the top individual rates) and the same income earned by a corporation and then distributed to the individual (with the distribution also taxed at the top individual rate). Ordinary income earned directly by a taxpayer is taxed at a top rate of 40.8% under the new law.²² If this same income is earned in by a corporation, the income is now taxed at a top rate of 21%.²³ If the after-tax corporate income is then distributed to the taxpayer as a dividend, the proceeds are again

22. For example, ordinary investment income such as interest and rents is taxed at a top marginal rate of 37% under sections 1(a) and (j), plus the 3.8% Net Investment Income Tax under section 1411.

23. I.R.C. § 11(b).

taxed at top rate of 23.8%.²⁴ Despite these two layers of tax, the income earned through the corporation and then immediately distributed is taxed at a combined effective rate of 39.8%,²⁵ still less than the 40.8% rate if the income were earned directly by the individual.

This example illustrates how the reduction in the corporate rate under the tax legislation favors income earned by corporations relative to income earned by individuals. Furthermore, even if the corporate income were immediately subject to the second individual layer of tax (on capital gains or dividends), the combined rate is still slightly lower than the top ordinary rate for individuals.

The benefit from earning income through a corporation is much greater, however, if the taxpayer can defer or entirely eliminate the second individual layer of tax. If the taxpayer can defer the second individual layer of tax by delaying distributions from the corporation, they can enjoy the benefit of what is essentially a loan from the government, equal to the amount of taxes that are delayed to future tax years. This loan benefits the taxpayer if the tax rate on the returns to investment within the corporation is lower than the tax rate on those returns outside the corporation. If the taxpayer can entirely eliminate the individual layer of tax, the taxpayer's earnings would *only* be taxed at the 21% percent corporate rate, instead of the top individual rate in excess of 40%, allowing the taxpayer to cut their tax bill almost in half.

2. How to Defer or Eliminate the Second Individual Layer of Tax

The second step of the two-step—deferral or elimination of the second layer of tax—can involve a combination of different strategies. The first strategy is simply to not distribute funds out of the corporation for some period of time, thus avoiding the tax on dividends, and not selling the stock, thus avoiding the capital gains rates. If the stockholder wants access to cash, they can borrow against the stock (using the stock as collateral) without triggering recognition of the income. This strategy defers the second layer of tax, reducing its actual cost to the taxpayer in present value terms.

24. The top marginal rate of 20% for qualifying dividends under section 1(h)(11) plus the 3.8% Net Investment Income Tax under section 1411.

25. $21\% + (23.8\% \times [1 - 21\%])$.

The taxpayer can then super-charge the tax advantage and completely eliminate the second layer of tax in several different ways. The first and perhaps easiest (from a tax planning perspective) strategy is to simply die while holding the corporate stock. The 2017 tax legislation retained the step-up in basis at death, which eliminates any built-in gain on assets held at that time.²⁶ As a result, the appreciation in the corporation stock resulting from the corporate earnings is not taxed to either the stockholder or their heirs and escapes the income tax altogether. The income is only taxed once at the lower 21% corporate rate.

Death is not the only way for a taxpayer to escape the second individual layer of tax. A taxpayer planning for retirement can achieve a similar result by holding their corporate shares in a Roth retirement account. Upon retirement, the taxpayers would pay no additional tax either from receipt of distributions from the corporation or from sales of their corporate interests.²⁷

Taxpayers can reduce or eliminate the second individual layer of tax on corporate distributions through other tax rules. For instance, section 1202 of the Internal Revenue Code provides for at least partial exclusion of gain from certain small business stock.²⁸ Taking advantage of this provision allows a taxpayer to partially avoid the second layer of tax on qualifying corporate distributions. Even more simply, a taxpayer can wait to receive distributions from the corporation until they are no longer working, and are consequently taxed in a lower individual income tax bracket.

Of course, taxpayers could engage in these same strategies under prior law.²⁹ The key difference is that, before the 2017 tax

26. I.R.C. § 1014.

27. *Id.* § 408A(d). The tax benefits of holding a closely held corporation through the Roth IRA may be disallowed in a case where a taxpayer does not engage in arm's length transactions with the corporation. See INTERNAL REVENUE SERV., NOTICE 2004-8 - ABUSIVE ROTH IRA TRANSACTIONS (2018), <https://www.irs.gov/businesses/notice-2004-8-abusive-roth-ira-transactions>. Taxpayers have apparently managed to overcome these rules when it comes to closely held corporations; for instance, this apparently includes putting founder's stock into Roth IRAs. See U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-15-16, INDIVIDUAL RETIREMENT ACCOUNTS: IRS COULD BOLSTER ENFORCEMENT ON MULTIMILLION DOLLAR ACCOUNTS, BUT MORE DIRECTION FROM CONGRESS IS NEEDED 26-27 (2014).

28. I.R.C. § 1202.

29. See, e.g., EDWARD J. MCCAFFERY, THE OXFORD INTRODUCTIONS TO U.S. LAW, INCOME TAX LAW xix, 12-15 (Dennis Patterson ed., 2012) (describing the "Buy/Borrow/Die" strategy that allowed taxpayers to reduce their tax liability on corporate investments even prior to the 2017 tax legislation).

legislation, the cost of the higher 35% corporate tax rate limited the benefit from these strategies, such that the strategies were previously unattractive to many taxpayers.³⁰ By contrast, the structure of the income tax is poorly equipped to address the post-legislation scenario in which corporate income is taxed at a much lower top rate than is individual income. Thus, if Congress intends to preserve the low corporate tax rate, new rules will be needed to prevent widespread abuse.

3. Current Anti-Abuse Rules Are Insufficient

Taxpayers will not be able to use these strategies without limit, and these transactions may be subject to judicial, statutory, and regulatory anti-abuse rules.³¹ However, many of these anti-abuse rules rely on IRS enforcement action, and these doctrines have been “notoriously ineffective” in the past.³² Further, we expect that the resource-constrained IRS will face significant barriers to addressing all of these gaming opportunities, especially in the short term. We also expect that the proliferation of new gaming opportunities will lead to a further diversion of taxpayer resources away from productive activity and towards tax planning.

B. EXAMPLES OF TAX GAMING USING CORPORATIONS

The discussion above described the basic strategies to reduce or avoid tax by earning income through corporations. To illustrate the potential tax benefits from these strategies, we here use a set of simple hypotheticals involving \$1,000 earned and invested by the taxpayer in various ways. In all the cases, we assume a relatively low pretax annual return of 4% if the funds are invested in fixed-income assets for a period of ten

30. That is, even if a taxpayer could eliminate the second individual level of tax, corporate earnings would still be subject to tax at the higher 35% rate, as opposed to 21% under the 2017 tax legislation.

31. These may include judicial principles such as assignment of income and the economic substance doctrine, statutory provisions such as section 269A of the Internal Revenue Code (personal services corporations), section 482 (allocation of income and deduction among taxpayers), section 531 (accumulated earnings tax), and section 542 (personal holding companies), and regulations that the IRS may promulgate pursuant to those provisions and the new tax legislation.

32. Michael L. Schler, *Reflections on the Pending Tax Cut and Jobs Act*, 157 TAX NOTES 1731, 1733 (2017). For example, the section 541 Personal Holding Company penalty may be avoided by combining the corporate investments with any business activity with sufficient gross income, even if the business activity is not otherwise profitable. *See id.*

years.³³ If we were to assume a higher rate of return or a longer holding period, some of the tax savings become more substantial. The discussion also assumes that any income from investment or labor is subject to the tax at the highest marginal rates.

1. Investing Through a Corporation

Assume that an individual taxpayer purchases a fixed-income investment, such as a corporate bond that pays an annual return of 4%, and the individual is already in the top income tax bracket due to their other taxable income for the year. The investment return would be taxed at the 40.8% rate,³⁴ for an annual after-tax return of 2.37%.³⁵ After ten years, the compounded investment value would grow to approximately \$1,264.³⁶

Compare this result to the case where the taxpayer contributes the \$1,000 bond to a corporation, and the investment returns accrues within the corporate solution.³⁷ If the 4% annual return is taxed at the 21% corporate tax rate, the investment earns an after-tax rate of return of 3.16%.³⁸ After ten years, the investment would grow to approximately \$1,365.³⁹ If this amount is distributed to the taxpayer, they will be taxed on \$365 of net dividend income⁴⁰ at the 23.8% rate, for an after-tax return of approximately \$1,278.⁴¹ Even with the double tax, the investor has increased their after-tax return by more than 5%, simply by investing through a corporation.⁴²

Now consider the result if the taxpayer dies at the end of Year Ten, while the investment is still held by the corporation, and the investor's heirs receive a stepped-up basis in the corporate shares.⁴³ The heirs will take a basis in their shares equal to

33. This example builds on analysis presented by Michael L. Schler. *Id.* at 1732–33.

34. *See supra* note 22.

35. $4\% \times (1 - 40.8\%)$.

36. $\$1000 \times (1.0237^{10})$.

37. Assume that the corporation has other business activities and will not be subject to the personal holding company tax under section 541 of the Internal Revenue Code, or the other anti-abuse rules. *See supra* Part I.A.3.

38. $4\% \times (1 - 21\%)$.

39. $\$1000 \times (1.0316^{10})$.

40. I.R.C. § 301(c) (2017).

41. $\$1365 - (\$365 \times 23.8\%)$.

42. That is, the taxpayer realizes \$278 in after-tax earnings by investing through a corporation, instead of \$264 in after-tax earnings by investing directly as an individual. $(\$278 - \$264) / \$264 = 5.3\%$.

43. I.R.C. § 1014.

the fair market value of \$1,365, and the entire \$365 of income entirely escapes the individual layer of tax. In this case the taxpayer earns a 38% after-tax premium by holding the investment in a corporation.⁴⁴

A taxpayer can use a similar strategy to reduce the effective tax rate on investments in dividend-paying stocks, even though the dividends would in any event be taxed at a preferential rate to the individual investor.⁴⁵ This is because dividends paid to the corporation would benefit from the 50% (or greater) dividends received deduction under the tax legislation.⁴⁶ As a result, the same dividend income, if earned by a corporation would be taxed at rate of only 10.5%, rather than the 23.8% top individual rate.

Of course, a taxpayer could achieve similar results even prior to the tax legislation, and without the use of a corporation, if the taxpayer simply invested in appreciating assets that do not generate current income. By allowing corporations to be used as tax shelters, however, the tax legislation dramatically expands the availability of this strategy, and the scope of investments that could be shielded from the individual layer tax.

2. Transforming Labor Income into Corporate Profits

Now consider how the taxpayer earned the \$1,000 available for the investment. Assume that the taxpayer earns this money as labor income, for instance, in the form of compensation for services. Here, too, a low corporate tax rate can be used to shield a portion of that labor income from tax. Assume, for example, that the taxpayer already facing the top marginal individual income tax rate earns an additional \$1,000 of labor income. In this case, the taxpayer's marginal tax rate is approximately 40.2%.⁴⁷

44. $(\$365 - \$264) / \$264 = 38.26\%$.

45. I.R.C. § 1(h)(11).

46. *Id.* § 243.

47. This approximate top rate of 40.2% on labor income is slightly lower than the 40.8% top individual rate described in the table above in the case of ordinary investment income such as interest and rents. The 40.2% rate is comprised of several separate taxes. First, the income would be subject to top the individual income tax rate of 37%. *Id.* § 1(a)–(d). It would then also face the Medicare surtax and Medicare payroll taxes. The Medicare surtax on employee income is under 0.9%. *Id.* § 3101(b)(2). Medicare payroll taxes are divided between the employee and employer. The employee-side tax is 1.45%. *Id.* § 3101(b)(1). The employer-side tax under section 3111(b) is 1.45% as well but, because the tax is effectively deductible from other taxes, the maximum effective cost of the employer-side tax is less than 1.45%. *Id.* § 3111(b). Most economists believe that the employer-side payroll tax is effectively borne by labor. *See*

If that income is also taxed at the top ordinary income tax rate, the individual will have only \$598 available to invest after-tax.⁴⁸ If this after-tax amount is invested at the annual 2.37% individual after-tax rate of return described above, the income will grow to only approximately \$756 over a ten-year period.⁴⁹

If, however, the taxpayer's income is earned through a corporation, the same \$1,000 of income will be taxed at a 21%, leaving \$790 available for the corporation to invest.⁵⁰ At the annual 3.16% corporate after-tax rate of return described above, the income will grow to approximately \$1,078 over a ten year period.⁵¹ If that income is subsequently distributed and subject to a second individual layer of tax of 23.8%, the taxpayer will receive approximately \$821—an approximately 9% after-tax premium by using a corporation on the combined return from working and from investment.⁵² The savings are then supercharged if the taxpayer can entirely eliminate the second individual layer of tax—through a step up in basis (or through keeping the corporate stock in a Roth as described below). In this case, the \$1,078 faces no additional individual layer of tax, and the taxpayer earned a premium of approximately 43%⁵³ by both sheltering their labor income and investing the after-tax proceeds through the corporation.

CONG. BUDGET OFFICE, THE DISTRIBUTION OF HOUSEHOLD INCOME AND FEDERAL TAXES 26 (2013). This means that the tax results in lower taxable wages (since employers reduce wages to pay the tax). The reduction in wages, however, reduces the other taxes owed (including the taxes owed through the employer-side payroll tax). The net effect is that, if the highest marginal rates are in effect, the 1.45% tax rate becomes approximately a 0.9% tax rate, after taking into account these interactions. As a result, the 37% top rate, plus the 1.45% employee-side payroll tax, plus the 0.9% employee Medicare surcharge, plus the net employer-side tax of approximately 0.9% yields a total top rate of tax on ordinary labor income of approximately 40.2%. The calculation is comparable in the case of a self-employed worker under section 1401(b), where the worker is responsible for all of the Medicare payroll taxes. I.R.C. § 1401(b). But the employer-equivalent portion of the tax is similarly deductible from the self-employed worker's taxable income. *Id.* § 164(f).

48. $\$1000 - (\$1000 \times 40.2\%)$.

49. $\$598 \times (1.0237^{10})$.

50. A taxpayer may not be able to shield all of their labor income in this manner, if the corporation is required to pay reasonable compensation to the taxpayer; *cf.* Rev. Rul. 74-44, 1974-1 C.B. 287 (recharacterizing dividends paid by an S-corporation to its shareholder as reasonable compensation). In all events, the corporation would be able to shield any amount in excess of reasonable compensation paid by the corporation.

51. $\$790 \times (1.0316^{10})$.

52. $(\$821 - \$756) / \$756$.

53. $(\$1078 - \$756) / \$756$.

As these examples demonstrate, taxpayers who can earn their labor and investment income through a corporation (and have it accrue in the form of corporate profits) will be able to shield that income from the higher individual rates.

3. Gaming by Shareholder-Employees in a Closely Held Corporation

Shareholder-employees in a closely held corporation can achieve similar tax benefits by reducing their wages paid out by the corporation, and thereby increasing the corporation's retained profits. In effect, the shareholder-employees can attain the benefit of immediately reinvesting their pre-individual-income-tax labor income within the corporation, where it can then accrue returns at the lower corporate tax rate.

The tax advantage in this scenario is generally the same as in the above examples. The primary difference in this case is that a taxpayer who is both a shareholder and employee of a closely held corporation does not need to go through the additional step of incorporating in order to shield a portion of their labor income. For instance, if a taxpayer were to earn \$1,000 of additional salary from a corporation, this income would be taxed at the ordinary income rate, leaving only \$598 available to invest. By contrast, if the taxpayer foregoes a portion of her salary in exchange for greater retained earnings in the corporation, this amount would instead be taxed at the lower corporate tax rate (in the form of higher net corporate income). The corporation may then invest the after-tax amount of \$790, which will similarly accrue at the corporation's higher after-tax rate of investment return—and with the total amount of savings depending on whether the second layer of tax is avoided or not.

4. Section 962 Election

Wealthy individuals could also use a foreign corporation to nearly halve their tax rate on ordinary income and short-term capital gains, and entirely avoid some of the existing anti-abuse rules, with an obscure election under section 962.

Very generally, section 962 allows a “United States shareholder”⁵⁴ of a “controlled foreign corporation”⁵⁵ (a CFC) to elect

54. A U.S. shareholder is a U.S. person (such as a U.S. resident individual) who owns, or is treated as owning, 10% of the voting power or value of a foreign corporation. I.R.C. § 951(b) (2017).

55. A controlled foreign corporation is a foreign corporation 50% of the vote or value owned (or treated as owned) by U.S. shareholders. *Id.* § 957(a).

to be taxable with respect to the Subpart F income (generally passive income like interest and capital gains) of his or her CFC as if the U.S. shareholder held the CFC through a U.S. corporation.⁵⁶ Accordingly, a U.S. shareholder who makes the election is taxable at a 21% rate with respect to the undistributed Subpart F income of the CFC (the same as if the CFC were owned by a U.S. corporation). However, if the CFC makes an actual distribution, the shareholder is subject to an additional tax (i.e., analogous to dividend income from a C corporation) to the extent of 79% of the income (i.e., $100\% - 21\%$).⁵⁷

Thus, a wealthy individual could form a Cayman Islands corporation, contribute cash, and have the Cayman Islands corporation purchase bonds and hold them, or purchase securities and actively trade them. Rather than be subject to tax at the 40.8% individual rate on the interest income and short-term capital gains,⁵⁸ the individual would be subject to tax at the 21% corporate rate. This strategy is tax-efficient so long as the individual does not need distributions from the Cayman Islands corporation, is able to fund the current 21% tax liability from other sources, and the Cayman Islands corporation does not earn any significant U.S. dividend income.⁵⁹

The anti-abuse rules that are intended to prevent individuals from indefinitely holding their passive assets in C corporations⁶⁰ have no application to a Cayman Islands corporation that

56. *See id.* § 962; Treas. Reg. § 1.962-1(a) (1976) (stating that if a section 962 election is made, the individual is subject to tax in an amount equal to the tax which would be imposed under section 11 if the amounts of taxable income were received by a domestic corporation).

57. The second tax upon an actual dividend is subject to tax at ordinary income rates (i.e., 40.8% maximum rate [$37\% + 3.8\%$]) unless the dividend is qualifying dividend income, in which case it would be taxable at a 23.8% rate. *Smith v. Commissioner*, 151 T.C. No. 5 (2018).

58. *See supra* note 22.

59. As mentioned above, dividends from the Cayman Islands corporation would be subject to a second tax. *See Shaviro, supra* note 2 and accompanying text. Therefore, to avoid this tax, the individual would not want to receive dividends. This structure is not tax-efficient for portfolios that generate a significant amount of U.S.-source dividend income. Undistributed dividend income would be subject to a 44.7% effective rate. 44.7% is equal to a 30% U.S. withholding tax plus a 21% tax on the remaining 70% of the dividend (after the U.S. withholding tax).

60. *See I.R.C.* §§ 269A, 531, 542.

is the subject of a section 962 election. The personal holding company tax does not apply to foreign corporations.⁶¹ While the accumulated earnings tax does apply to foreign corporations,⁶² for purposes of determining accumulated taxable income, amounts included under section 951(a) (which includes Subpart F income) are allowed as a deduction.⁶³ If the Cayman Islands corporation holds only securities, all of its income will be Subpart F income that is included under section 951(a). Therefore, the Cayman Islands corporation should not have any accumulated taxable income and should not be subject to the accumulated earnings tax.⁶⁴

Upon the individual's death, his or her heirs would receive ownership of the Cayman Islands corporation with a stepped-up basis.⁶⁵ The stepped-up basis would enable the heirs to sell their interests in the Cayman Islands corporation without tax. A foreign buyer could then liquidate the appreciated positions of the foreign corporation without U.S. tax.⁶⁶ Therefore, the foreign buyer would be unlikely to significantly discount the purchase price. This is a much better result than had the individual held his or her portfolio in a U.S. corporation, which would be subject to U.S. corporate tax upon a liquidation.

The bottom line is that holders of debt and traders in securities have a relatively easy way to nearly halve their taxable rate (from 40.8% to 21%) with a Cayman Islands corporation and a tax election. This strategy also neatly avoids the anti-abuse rules that are designed to prevent individuals from accumulating earnings in a C corporation. Of course, this strategy is available only to the wealthiest individuals (who have capital, can afford to set up a Cayman Islands corporation, and can fund tax liability without distributions). Although section 962 has been in the Code since 1962, it has been only rarely used and there is no

61. *Id.* § 542(c)(5).

62. *See generally id.* § 535.

63. *Id.* § 535(b)(10).

64. There may be other ways to plan around the anti-abuse rules, but here, by statute, they simply do not apply. Furthermore, the passive foreign investment company (PFIC) rules, another set of anti-deferral rules, do not apply because the CFC rules trump that regime if both are applicable. *Id.* § 1297(d).

65. *Id.* § 1014. The stepped-up basis would be equal to fair market value as of the date of the individual's death.

66. The heirs would want to sell to a foreign person. Under section 1.962-3(c) of the Treasury Regulations, if a U.S. person acquires stock of a foreign corporation with respect to which a section 962 election has been made, the acquirer is subject to the additional tax described above upon an actual distribution. Treas. Reg. § 1.962-3 (1965).

evidence that Congress appreciated that a reduction in the corporate tax rate could offer an opportunity for high-income individuals to dramatically reduce their tax rate on interest income and short-term capital gains.

C. REFORM POSSIBILITIES

For the reasons explained above, gaming opportunities will arise whenever the corporate tax rate is set substantially below the top individual income tax rate.⁶⁷ Smaller-scale reforms could discourage certain games or limit the potential tax benefits. Yet, more fundamental reforms will be needed if the corporate tax rate is kept well below the top individual income tax rate. We discuss some options for both partial and fundamental reforms below.

1. Partial Reforms

One simple but effective partial reform would be to eliminate the provision providing for stepped-up basis at death. Eliminating this provision would prevent taxpayers from completely avoiding the individual layer tax on corporate investments held for their entire lifetime.

This partial solution, however, would still preserve significant tax planning opportunities. For instance, this reform would not affect strategies based on using Roth retirement accounts or other techniques for circumventing the second layer of tax, as explained above.

A number of prior scholarly works advocate repealing the stepped-up basis at death.⁶⁸ The 2017 tax legislation's reduction of the corporate tax rate to well below the top individual income

67. Others have published related discussions of these issues. *See, e.g.*, Shawn Bayern, *An Unintended Consequence of Reducing the Corporate Tax Rate*, 157 TAX NOTES 1137 (2017); Schler, *supra* note 32; Adam Looney, *The Next Tax Shelter for Wealthy Americans: C-Corporations*, BROOKINGS: UP FRONT BLOG (Nov. 30, 2017), <https://www.brookings.edu/blog/up-front/2017/11/30/the-next-tax-shelter-for-wealthy-americans-c-corporations>. There are also formative works on the use of a corporation as a tax shelter. *See generally* STEVEN A. BANK, FROM SWORD TO SHIELD: THE TRANSFORMATION OF THE CORPORATE INCOME TAX, 1861 TO PRESENT (2010); Edward D. Kleinbard, *Corporate Capital and Labor Stuffing in the New Tax Rate Environment* (Univ. S. Cal. Ctr. L., Econ. & Org., Research Papers Series No. C13-5; Univ. S. Cal. Gould School of Law, Legal Studies Research Paper Series No. 13-5, 2013).

68. *E.g.*, Richard Schmalbeck, Jay A. Soled & Kathleen DeLaney Thomas, *Advocating a Carryover Tax Basis Regime*, 93 NOTRE DAME L. REV. 109 (2017); Lawrence Zelenak, *Taxing Gains at Death*, 46 VAND. L. REV. 361 (1993).

tax rate greatly strengthens the case for and urgency of eliminating (or at least reforming) the stepped-up basis rules.

Another partial reform would be to limit the tax gaming opportunities related to using the dividends-received deduction. The 2017 tax legislation reduced the deduction for dividends received from an unaffiliated domestic corporation (from 70% to 50%).⁶⁹ This change, however, still preserves a low (10.5%) corporate tax rate on dividends received. Further reducing or eliminating the deduction for dividends-received from unaffiliated domestic corporations would make it less attractive for taxpayers to stuff corporations with dividend-paying equities. Meanwhile, this reform will not interfere with the planning decisions of corporations that use affiliated subsidiaries for business purposes. Of course, this reform would only discourage gaming from stuffing corporations with dividend paying stocks. Nevertheless, combined with reforming or eliminating the stepped-up basis rules and other accompanying reforms, this could be an important element of a basket of partial reforms, and limit the scope of investments that a taxpayer would prefer to hold through a corporation.

Finally, Congress and Treasury could strengthen general anti-abuse rules in tax law, such as the personal holding company and accumulated earnings tax provisions.⁷⁰ However, overly restrictive limitations would interfere with corporations' legitimate business decisions as to when and how to deploy capital. Similarly, limitations on the ability to incorporate for tax purposes would require complex rulemaking and line-drawing. We are thus doubtful that strengthening anti-abuse rules will effectively prevent taxpayers from playing the games described in this Part.

2. Fundamental Reforms

If Congress remains committed to keeping the corporate tax rate well below the top individual income tax rate, more fundamental structural changes to the income tax will be needed to prevent the gaming opportunities explained above. One option would be for corporate earnings to be taxed immediately to the individual through either pass-through treatment (for small closely held corporations) or through a mark-to-market approach (for large publicly traded corporations).⁷¹ This change would in

69. I.R.C. § 243(a)(1).

70. *Id.* §§ 542, 532.

71. For elaboration on this reform option, see Eric Toder & Alan D. Viard,

turn allow for closing the rate gap between capital and labor income. Further, this package of reforms would neutralize the benefits of investing through corporations and allow for the reduction or even the elimination of the corporate tax. Other fundamental reform options could similarly allow for more consistent treatment of individual and corporate income,⁷² without inviting tax games or disproportionately benefitting wealthy taxpayers.

To reduce the benefits of section 962, Congress could provide that the personal holding company tax applies to a CFC with respect to which a taxpayer has made an election under section 962 and could deny the deduction from accumulated earnings tax for the Subpart F income of a CFC to the extent that the income is taxed at the corporate rate by reason of an election under section 962.

While there are multiple ways individuals can use corporations as a tax shelter, the government may be able to reduce these pressures while preserving the lower corporate tax rate through future reforms. Of course, sheltering income through a corporation may not be the most effective tax planning strategy for many taxpayers. This next Part describes alternative opportunities for tax gaming under the 2017 legislation through the new 20% pass-through deduction under section 199A.

II. THE FAULTY PASS-THROUGH DEDUCTION

Perhaps the most notorious change brought by the 2017 tax legislation was the newly introduced 20% deduction for certain qualified business income. In effect, this deduction reduces the top individual income tax rate from about 40.8% to 33.4% for those eligible.⁷³ This is a special break for business income not

Replacing Corporate Tax Revenues with a Mark-to-Market Tax on Shareholder Income, 69 NAT'L TAX J. 701 (2016).

72. See, e.g., Mark P. Gergen, *How to Tax Capital*, 70 TAX L. REV. 1 (2016) (proposing a flat annual tax on the market value of publicly traded securities); Ari Glogower, *Taxing Capital Appreciation*, 70 TAX L. REV. 111 (2017) (proposing a combined mark-to-market and retrospective taxation system); Edward D. Kleinbard, *The Right Tax at the Right Time*, 21 FLA. TAX REV. 208 (2017) (proposing to tax capital through a "Dual Business Enterprise Income Tax").

73. See Daniel Shaviro, *Evaluating the New U.S. Pass-Through Rules*, 1 BRIT. TAX REV. 49, 51 (2018) ("The pass-through rules stand front and centre in illustrating both the 2017 Act's sloppiness and its lack of principle."). The 20% deduction applies only against the top income tax rate of 37% and not the 3.8% Medicare surtax. As a result, the top rate on eligible pass-through income is $([37\% \times 0.8] + 3.8\%)$, or 33.4%.

earned via a corporation, which benefits from the rate cut described above. This deduction would make for questionable policy even if it were well-drafted.⁷⁴ But, clearly unnecessary gaming opportunities, arbitrary line drawing, and technical problems make this new deduction far worse.

The rules establish a complex framework for determining who does and who does not get the deduction. The main constraints include:

First, irrespective of income level, employees are not eligible for the deduction on their income,⁷⁵ and the income must be coming from a trade or business that the person carries on (plus certain other specified kinds of income).⁷⁶ There are also other constraints that apply to people earning their income in exchange for services (even if not employees), though these are probably easy to avoid.⁷⁷

Second, for those with taxable income above \$315,000 for a married couple (half that for a single individual), other constraints begin to kick in.⁷⁸ Business income is eligible so long as the business has a combination of enough employee wages and tangible property.⁷⁹ However, certain lines of business are ineligible for the deduction. This includes listed professions such as

74. The best policy justification for the provision is that reducing the effective marginal tax rate on pass-through businesses reduces the incentives for shifting business income into corporate structures, so as to take advantage of the new tax benefits using the strategies we explained in Part I. However, a number of us consider this to be a rather weak justification for the new deduction. See Shaviro, *supra* note 73, at 51 (“[The rules for the new deduction] function as incoherent and unrationalsed industrial policy, directing economic activity away from some market sectors and towards others, for no good reason and scarcely even an articulated bad one.”).

75. I.R.C. § 199A(d)(1)(B).

76. *Id.* § 199A(b)(1).

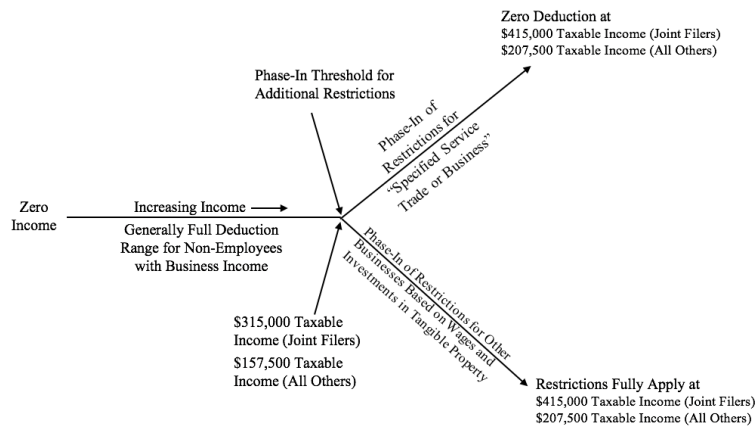
77. See *id.* § 199A(c)(4). The deduction does not apply to payments to service providers if it represents reasonable compensation for services, guaranteed payments, or payments to partners not acting in their capacity as a partner. The last two restrictions are specific to partnerships (and, as it happens, are easy for partners working at a partnership to avoid). The first—the restriction making “reasonable compensation” ineligible for the deduction—is potentially broader and could apply across the board. However, the concept of “reasonable compensation” has, up until now, only been used to attack tax avoidance among S corporation owners, and, in its proposed regulations, Treasury chose to limit the effect to that sector. Prop. Treas. Reg. § 1.199A-3(b)(2)(i)(H), Fed. Reg. 40,890, 40,890–97 (Aug. 16, 2018).

78. For married couples, the restrictions phase-in over a \$100,000 taxable income range above the threshold (and half that for a single individual). I.R.C. §§ 199A(b)(3), 199A(d)(3).

79. *Id.* § 199A(b)(2)(B).

performance of services in health, law, athletics, and the performing arts, as well as any trade or business in which the principal asset is the reputation or skill of owners or employees.⁸⁰

The figure below illustrates the basic application of these rules and how different rules apply depending on income level.



The rules surrounding the deduction provide tremendous incentives for taxpayers to attempt to shoehorn their income into the “qualified” category. The heart of the problem is the absence of a policy justification for many rules governing the deduction; these rules draw formalistic lines favoring some groups and industries, but not others, some of whom benefit and others who do not. These are lines across which taxpayers will play costly games.⁸¹

The next sections lay out, first, the kinds of games that taxpayers will play to qualify for the deduction, and, second, the recommended reform to section 199A—namely, its removal from the Code.

80. Specifically, section 199A(d)(2)(A), by way of cross-reference to section 1202(e)(3)(A), and in combination with section 199A(d)(2)(B), disfavors the following types of services: health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, and also any trade or business either “which involves the performance of services that consist of investing and investment management, trading, or dealing in securities . . . partnership interests, or commodities” or “where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees.”

81. As before, we are grateful to Mike Schler for his many insights on the pass-through games. See Schler, *supra* note 32, at 1734–41.

A. TAX GAMES TO QUALIFY FOR THE PASS-THROUGH DEDUCTION

Some favored taxpayers will reap the pass-through deduction windfall without the need for any games. For them, the only game is to be themselves. So, real estate developers, retailers, extraction industries like oil and mining, or any independent contractor below the income threshold would probably qualify. Notably, some professionals, such as architects and engineers, were moved in the conference bill from the “disfavored service” category to the “favored service” category. As a result, they are likely exempted from some of the restrictions placed on other service providers, and so presumably can be very highly paid and still get a partial or full deduction.⁸² There is no clear policy explanation for why these services are “favored” services, while doctors or those in the performing arts are still in the “disfavored” category—and that lack of policy justification pervades the provision as a whole and as it seems likely to be applied.

Many of the rules governing the new deduction are thus incoherent and arbitrary. Gaming opportunities then arise for taxpayers who do not automatically fall into one of the favored categories, but who can use various strategies to join the ranks of those so favored.

On August 8, 2018, Treasury issued proposed regulations to implement section 199A of the Treasury Regulations.⁸³ Some of these regulations are directly aimed at restricting the strategies

82. The status of engineers and architects under new section 199A, providing for the 20% deduction, is somewhat murky. The prior House and Senate versions of the legislation included (by way of cross-reference to section 1202(e)(3)) a list of *per se* specified service trades or businesses whose eligibility for the special rate would be limited (Senate version) or eliminated (House version). See I.R.C. § 199A. The final legislation removed engineering and architecture from that list (which now include health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, and brokerage services). However, the definition of specified service trades or businesses in the final legislation still includes (via cross-reference) “any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees.” *Id.* § 1202(3)(A). If that catch-all phrase were interpreted broadly, that would seem to capture most engineering and architecture businesses, and the removal of engineering and architecture from the list of *per se* specified services would prove to be futile. However, Treasury, in its proposed regulations, chose to very narrowly interpret that phrase, and, if that interpretation governs, highly compensated engineers and architects would get access to the deduction so long as they have either enough employee wages or tangible property. See *infra* notes 108–12 and accompanying text.

83. Prop. Treas. Reg. § 1.199A-1-A-6, 83 Fed. Reg. 40,884, 40,911–30 (Aug. 16, 2018).

for tax planning that we first identified in our earlier iterations of the *Games* papers. However, even as the regulations targeted discrete tax planning maneuvers, they very importantly and explicitly chose to allow most service providers—who weren't in the discrete, listed categories—to get access to the deduction. This left the door open for a number of tax planning maneuvers we describe.

1. Becoming a Non-Employee

The pass-through deduction is clearly denied to anyone who is an employee.⁸⁴ Yet this potentially remains good news for anyone who can quit their job and become either an independent contractor (and so be considered a sole proprietor) or a partner in a firm. The game is clear: do not be John Doe, employee. Be John Doe, independent contractor or partner in an LLC, receiving a profit share rather than wages.⁸⁵

Note that individuals who provide “specified services” (such as lawyers and doctors) must have taxable income of less than \$315,000 for a married couple (or half that for a single individual) to fully benefit from this game. Notably, taxable income is calculated *after* taking into account other deductions, like the standard deduction or itemized deductions. Thus, many well-off taxpayers who provide specified services will be under that threshold and still qualify for the deduction.⁸⁶ This gaming tech-

84. See I.R.C. § 199A(d)(1)(B).

85. Of course, there are many non-tax-law frictions that will deter many taxpayers from becoming non-employees. Our argument here is only that there are a good number of taxpayers whose economic situations potentially allow for transforming the status of their work from an employee relationship to an independent contractor or partner relationship and that the new pass-through deduction provides these taxpayers with substantial tax motivation for making this change. For discussion of some of the relevant non-tax considerations, see Shu-Yi Oei & Diane Ring, *Is New Code Section 199A Really Going to Turn Us All into Independent Contractors?* (Bos. Coll. Legal Studies Research Paper, 2018), <https://ssrn.com/abstract=3101180>.

86. In our original report, we had described this game as the “Law Firm Associates, LLC” loophole. Reuven Avi-Yonah et al., *The Games They Will Play: Tax Games, Roadblocks, and Glitches Under the House and Senate Tax Bills* (Dec. 7, 2017) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3084187. Given the new income restrictions, this game probably will not cover many of the highest paid law firm associates. Nevertheless, the income restrictions are not so high as to deny tax benefit to many law firm associates and similar taxpayers—who will thus be incentivized to form their own separate “Associates, LLC” firms. For instance, median base salary for a fourth-year associate in 2017 was \$155,000, an income level that would still qualify for the pass-through deduction. See Press Release, Sarah Ramirez, Nat'l

nique also applies, and without any income limit, to any “favored” business—like real estate—that is willing to turn an employee into a junior partner in the business.

The proposed regulations take limited aim at this particular game. Specifically, the regulations try to give the IRS some power to stop firms misreporting people as partners or independent contractors when they actually remain employees for purposes of section 199A based on the multi-factor test that governs that distinction.⁸⁷ The proposed regulations would create a presumption that someone who switches from being an employee to an independent contractor or partner at the same firm actually remains an employee. The presumption can be overcome with a showing that the economic relationship has in fact changed. Importantly, this presumption does not stop a former employee from taking the deduction if the economic relationship really does change, for instance changing the amount of direct supervision or dropping employee benefits (in order to convert someone into an independent contractor). Further, the presumption will only help to stop misclassification for existing employment relationships and not new ones.

The bottom line is that these techniques will cover a wide swath of relatively high-income taxpayers who were previously employees. Employers already have some incentive to characterize workers as independent contractor, and the IRS has faced serious challenges enforcing the tax distinction between the two.⁸⁸ This pressure will greatly increase with the added tax gaming incentives created by the new pass-through deduction. Moreover, for those employees who cannot easily recharacterize themselves as independent contractors, similar tax benefits can be achieved through the employees becoming partners in the relevant business.⁸⁹

Ass’n for Law Placement, Associate Salaries Rise in Some Markets, But National Median Remains Unchanged (June 1, 2017), <https://www.nalp.org/uploads/Research/AssociateSalarySurveyReportPressRelease.pdf>.

87. Prop. Treas. Reg. § 1.199A-5(d), 83 Fed. Reg. 40,884 (Aug. 16, 2018).

88. For the basic difficulties in distinguishing between employees and independent contractors for tax purposes, see David A. Weisbach, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, 84 CORNELL L. REV. 1627, 1632 (1999).

89. Note that the IRS might try to restrict this game of simply recharacterizing employees as independent contractors or as partners by arguing that the deduction does not apply to the degree that profits represent “reasonable compensation” for services. But as noted above, Treasury has indicated that it will only apply the “reasonable compensation” standard to S corporations, and the restrictions on partnerships are relatively easy to plan around. See Prop. Treas. Reg. § 1.199A-3(b)(2)(i)(H), 83 Fed. Reg. 40,890, 40,890–94 (Aug. 16, 2018).

2. Becoming a Favored Business Through “Cracking” and “Packing”

What if doctors recharacterize themselves as partially providing other goods or services like beauty or wellness products? Or, what if lawyers go in-house at a real estate firm? In playing these kinds of games, they might be able to at least get partial access to the 20% deduction.

The highest paid doctors and lawyers (and those in other professions that are specifically listed) would not be directly eligible for the 20% write off since they are in restricted “specified service” industries, which covers certain listed professionals above the income threshold.⁹⁰

Yet these restricted professionals can potentially still game the new pass-through deduction rules through two basic strategies which we will call “cracking” and “packing.”⁹¹ That was the conclusion we reached in our earlier *Games* papers.⁹² The terminology we coined quickly entered the “popular” tax discourse, and such planning apparently got underway.⁹³ Treasury seemed to agree with us that it could be a significant problem, and, in its proposed regulations, tried to deal with some of these strategies—and especially some forms of “cracking”—but certainly not all.⁹⁴

a. “Cracking”

The essence of the “cracking” strategy is to separate (“crack apart”) the revenue streams from the service partnership, so that as much income as possible can qualify for the deduction.

In the proposed regulations, Treasury tries to shut down a specific form of what might be called fake cracking.⁹⁵ This is where owners split apart overhead and support services from a

90. See Qualified Business Income Deduction, Prop. Treas. Reg. §§ 1.199A-1.643, 83 Fed. Reg. 40,884, 40,899 (Aug. 16, 2018) (to be codified at 26 C.F.R. pt. 1).

91. This terminology borrows from gerrymandering strategies. See *Election Boundaries: No More Packing or Cracking*, ECONOMIST, June 16, 2011, at 49.

92. See Avi-Yonah et al., *supra* note 86, at 25–29 (addressing potential “Pass-Through Eligibility Games”).

93. E.g., Ruth Simon & Richard Rubin, *Crack and Pack: How Companies Are Mastering the New Tax Code*, WALL ST. J. (Apr. 3, 2018), <https://www.wsj.com/articles/crack-and-pack-how-companies-are-mastering-the-new-tax-code-1522768287>.

94. See Qualified Business Income Deduction, Prop. Treas. Reg. §§ 1.199A-1.643, 83 Fed. Reg. at 40,884 (Aug. 16, 2018) (proposing defenses to cracking).

95. *Id.*

specific service business, put those in a separate entity all or largely owned by the same people, and then try to strip out profits from the specified service business. But, two other forms of cracking apparently still work: first, cracking apart lines of “outward facing” business (not overhead and support services), some of which are specified services and some of which are not, and second, what we call “real cracking” of overhead and support services where they are owned by different people.

The kind of fake cracking strategy addressed by the proposed regulations can be illustrated by the following examples: the partners in a law firm set up a separate real estate investment trust (REIT). The REIT is automatically eligible for the pass-through rate, without any requirement that the REIT pay W-2 wages or hold sufficient tangible property.⁹⁶ The REIT would hold all of the law firm’s real estate assets. Then, the REIT could charge the law firm the maximum rent that could plausibly be justified for use of these assets (based on property valuations) in order to transform some of the law firm’s legal service income into rental income earned by the REIT. This rental income would then qualify for the pass-through deduction.⁹⁷

For another example, a doctors’ or lawyers’ office could form a separate firm which owns ancillary support services like accounting, document management, software, and so on. Similar to the REIT strategy above, the game would then be to essentially overcharge the main firm for these ancillary services, so as to transform some of the main firm’s revenue into a form that qualifies for the pass-through deduction.⁹⁸

96. I.R.C. § 199A(b)(1)(B) (2017). However, the REIT strategy would have faced the challenge of navigating the related-party rules governing REIT eligibility. That may have been hard to do, especially for firms with few owners. *See* I.R.C. § 856(d)(2)(B) (restricting REIT-treatment when rents are paid by related parties). An alternative, avoiding these REIT restrictions, would have been to have the real estate simply held by another partnership with the same owners as the law firm. In that case, this separate partnership would have needed a combination of enough W-2 wages or tangible property to unlock the deduction. I.R.C. § 199A(b)(2). In this case, the partnership would have held a significant piece of tangible property, the law office itself, helping to unlock the deduction.

97. Victor Fleischer first described something like this arrangement on Twitter. Victor Fleischer (@vicfleischer), TWITTER (Nov. 2, 2017, 8:48 PM), <https://twitter.com/vicfleischer/status/926294879998758912>.

98. Note that, unlike with the REIT version of this strategy, these subsidiary firms would need to pay sufficient W-2 wages or hold enough tangible property through the new businesses in order to qualify earnings for the pass-through deduction. I.R.C. § 199A(b)(2).

The proposed regulations try to shut down these fake cracking strategies.⁹⁹ The regulations require these closely related businesses—owning the real estate and support services—to be aggregated with the listed service business single even if operating across different entities.¹⁰⁰ That is the case if there is 50% or more common ownership.¹⁰¹

These parts of the proposed regulations seem likely to be upheld if they are finalized in this form and shut down some of the easiest fake cracking strategies. Nonetheless, cracking will remain a planning strategy. That is because at least two cracking strategies apparently survive.

First, there is the cracking apart of outward facing businesses, some of which are specified service businesses and some of which are not. By “outward facing,” we mean that the cracked businesses provide services or goods to outside consumers, and they aren’t just one cracked business providing support services to the other. In that case, the activities should be placed in separate businesses, potentially in different entities that might even have the same set of owners.¹⁰² There are two key goals for the strategy: (1) Do not let the specified services infect the profits

99. Qualified Business Income Deduction, Prop. Treas. Reg. §§ 1.199A-1.643, 83 Fed. Reg. at 40,895–901 (Aug. 16, 2018) (explaining the proposed § 1.199A-5).

100. *Id.*

101. Prop. Treas. Reg. § 1.199A-5(c), 83 Fed. Reg. 40,923, 40,926–27 (Aug. 16, 2018). There are two aggregation rules applying to businesses with 50% or more common owners with a listed service business under the proposed regulations. First, if the cracked business provides 80% or more of its services or property to the listed business, the cracked business is simply aggregated entirely with the listed business. Although partners of a law firm might own their own building via a separate entity, the building is considered to be part of the law firm’s trade or business. Second, if the cracked business is under the 80% threshold, then the portion of the services or property provided to the listed business is considered to be part of the listed business. So, if partners in a law firm own a large building and rent out much of it to other businesses, the law firm’s rent would be considered to actually be income of the listed business (the law firm) for purposes of section 199A.

102. It is actually ambiguous what it takes to effectively “crack” businesses under section 199A and get them treated as separate businesses for these purposes. The proposed regulations suggest that the definition of trade or business is the same as under section 162, but that provides little guidance. Prop. Treas. Reg. § 1.199A-1(b)(13), 83 Fed. Reg. 40,884, 40,911 (Aug. 16, 2018). At one point, in the preamble to the proposed regulations, Treasury suggests that running the businesses in separate entities should normally suffice to crack a business, and so that might be the safest route for taxpayers. Prop. Treas. Reg. § 1.199A-4, 83 Fed. Reg. 40,884, 40,894 (Aug. 16, 2018) (“[I]n most cases, a trade or business cannot be conducted through more than one entity.”).

made from other activity so that those other profits remain eligible for section 199A. (2) If the two businesses share items like overhead costs, try to attribute as much of the profits to the eligible business as possible by assigning as much of the shared costs to the specified service business as owners can. The IRS of course may try to prevent such shifting of expenses (and thus profits). However, these kinds of games among related parties are difficult to police as it requires the IRS to try to identify the “right” way to share expenses—such as the right amount of wages of common employees to attribute to one business versus the other.¹⁰³

Second, *real* cracking of overhead and support services—where the businesses do not have common ownership—could still reduce tax bills. Specifically, law firms and other listed businesses that now do not own their own buildings or provide their own support services will be at an advantage under section 199A. That is because, if the building or support services are really owned by others, those other owners can take the section 199A deduction on their streams of income (despite providing real estate and support to the listed business), and the tax savings can be split among all of the relevant parties. So, in these cases, fake cracking is out; real cracking is in.

b. “Packing”

The other strategy for becoming a favored business—“packing”—is to add (“pack”) other qualifying business activities into the service partnership, transforming the combined entity into one that is not primarily providing disfavored services.¹⁰⁴

The proposed regulations address this strategy too, to a limited degree. Namely, the regulations provide a *de minimis* rule indicating that, if only a very small share of the receipts are from listed services, then the business is out from the restriction.¹⁰⁵

103. The proposed regulations only seem to restrict this cracking strategy to the degree that the non-listed outward facing services are considered “incidental” to the specified trade or business. The proposed regulations define an incidental non-listed business as one meeting the following criteria: 50% or more common ownership with a listed service business; shared expenses with that specified service business; and gross revenues that are 5% or less of the combined revenues of the listed service business and the non-listed one. If the non-listed business is incidental, then the deduction isn’t available for it. Thus, cracking apparently works so long as the non-listed activity is large enough relative to the listed activity to cross the 5% of revenue threshold. See Prop. Treas. Reg. § 1.199A-5(c)(3), 83 Fed. Reg. 40,884, 40,926 (Aug. 16, 2018).

104. Thanks to Adam Looney for pointing out this strategy.

105. Prop. Treas. Reg. § 1.199A-5(c)(1), 83 Fed. Reg. 40,884, 40,926 (Aug. 16,

The proposed rules say that, if less than 5% of gross receipts for large firms (and 10% for small firms) are due to the listed services, the entire trade or business gets the deduction.¹⁰⁶

At first blush, it might appear that, under the proposed regulations, stuffing has no role to play. After all, it would require a lot of stuffing to reduce listed activity to less than 5% of a firm's gross receipts. Further, businesses would not want to risk crossing that threshold since, in that case, the listed service business appears to infect everything else in that trade or business.

But, some easy strategies seem to survive. For instance, let us say a lawyer goes in-house at a real estate firm, packing her "bad" services into a "good" trade or business. It's not even clear that the services she provides within the firm count toward the 5% threshold of gross receipts or how that would be measured. She might—and probably does—get the full deduction, and it seems unlikely that the IRS would try to argue that in-house counsel could lead to infection of all the business's activities.

3. Not Being in One of the Listed Categories

Perhaps most obviously, one way to get access to the deduction is for high-income service providers to try to define their activity as not being listed. For those clearly covered by the listed categories (a lawyer at a law firm, a surgeon, and so on), this will not work, but, for others at the borderline (and there might be a surprising number of people at those borders), there is substantial incentive to try to get outside the listed categories.

Here, the proposed regulations aggravated problems rather than the opposite. For those above the income threshold, section 199A lists certain professions that don't get the deduction (health, law, etc.), and then includes a catch all category of any business in which the principal asset is the reputation or skill of the owners or employees.¹⁰⁷ If Treasury had read that catchall broadly, then the catchall could not be easily avoided by high-income service providers, and there would be far less pressure on exactly how the other listed professions get defined.

a. Gaming "Reputation or Skill"

In earlier iterations of *Games*, we suggested that the "reputation or skill" catchall could be gameable—avoided through a

2018).

106. *Id.*

107. Prop. Treas. Reg. § 1.199A-5(a)(2)–(3), 83 Fed. Reg. 40,884, 40,923–26 (Aug. 16, 2018).

“packing”-style strategy, combining activities and property together with reputation or skill.¹⁰⁸ Unlike in some other areas, Treasury in the proposed regulations did not address our concerns, and, instead, defined “reputation or skill” very narrowly.¹⁰⁹ If these regulations are finalized, this catchall will in fact catch very little, and the well-advised should be able to often escape.

The proposed regulations limit this catch-all to three situations: (1) income from product endorsements; (2) licensing fees for use of one’s image, name, and so on; and (3) fees for appearances at events, on radio, on television, or through other media formats.¹¹⁰ Those three situations of course do not cover many types of activities in which high income service providers are earning large returns based on reputation or skill. Instead, putting to the side the third limited category of appearance fees, this is focused only on the sale of reputation and reputation alone.

So, how can taxpayers avoid the catchall under the proposed regulations? Pack reputation with other activities. Consider, for example, an actor or actress with a generally positive reputation who uses that reputation to sell products. She should not license her name to a firm to take the deduction; that would get caught. Instead, she should mix that reputation with some labor. For instance, consider Gwyneth Paltrow’s “lifestyle brand” business—Goop—which sells products like face creams.¹¹¹ A business like this (if it were not incorporated, as is the case with Goop) would presumably qualify for the pass-through deduction, notwithstanding the centrality of the owner’s reputation.

In fact, the proposed Treasury regulations explicitly suggest that a famous chef would get the 20% deduction on the income from the restaurants she owns.¹¹² And, that is despite the fact that presumably the returns from those restaurants are, in significant part, a return to her reputation or skill. The chef simply would not get the deduction on licensing fees she receives from product endorsements, which means (for purposes of section

108. See Avi-Yonah et al., *supra* note 86, at 23–24 (“Once the business operations are packed together, it would be difficult for the IRS to argue that reputation is still the principal asset of the combined business.”).

109. See Prop. Treas. Reg. § 1.199A-5(b)(2)(xiv), 83 Fed. Reg. 40,884, 40,925 (Aug. 16, 2018).

110. *Id.*

111. See GOOP, <https://goop.com> (last visited Nov. 20, 2018).

112. Prop. Treas. Reg. § 1.199A-5(b)(3) Ex. 8, 83 Fed. Reg. 40,884, 40,926 (Aug. 16, 2018).

199A) she should be involved in the actual creation of those products—in which case, deduction.

Now, how about a certain real-estate mogul and reality TV star? Well, it depends. Under the proposed regulations, the licensing arrangements apparently do not get the deduction, but other activities, if combined with other investments and maybe the family's labor, seem to benefit. Trump Hotel, partly owned by the Trumps and run by them, gets in apparently.

b. Gaming the Other Listed Categories

With the “reputation or skill” catchall so easy to avoid, large tax differences ride on whether a high-income service provider falls into the other listed categories. And there is certain to be substantial litigation and planning on this front.

Take one seemingly simple category: that of health services. The proposed regulations further define those services as follows—“the provision of medical services by individuals such as physicians, pharmacists, nurses, dentists, veterinarians, physical therapists, psychologists and other similar healthcare professionals performing services in their capacity as such who provide medical services directly to a patient (service recipient).”¹¹³

There is then a key question: Is a medical professional only providing a listed service if providing “services directly to a patient”?¹¹⁴ The actual meaning of the regulation here is somewhat ambiguous. That phrase might only modify the catchall category of “other similar healthcare professionals” or it might modify the entire list and apply to everyone.

Let us say that the modifier applies to everyone and this is suggesting that those in health care fields—like medical researchers—who do not provide direct services are not included. Then, it is not just medical researchers who could get the deduction. It is doctors who do not directly see patients. Like pathologists. Or many radiologists. And they should make sure not to see patients in order to maintain their eligibility.

It is possible that Treasury addresses some of these issues in its final regulations and makes sure that the likes of pathologists and radiologists don't get the deduction. But, this same kind of trouble exists with many of the listed categories

113. Prop. Treas. Reg. § 1.199A-5(b)(2)(ii), 83 Fed. Reg. 40,884, 40,924 (Aug. 16, 2018).

114. *Id.*

and their definitions. What is “consulting” (also a listed service)?¹¹⁵ The proposed regulations answer that age-old question by defining consulting as “provision of professional advice and counsel to clients to assist the client in achieving goals and solving problems.”¹¹⁶ That definition could seem to potentially apply to almost every service provider or to very few, and, in the massive gray area, there will surely be many who gamble the IRS won’t challenge them and then litigation with those relative few that the IRS disputes.

4. Unprofitably Stuffing Property into the Business

In order to fully benefit from the pass-through deduction and even if the line of business restrictions is avoided, the relevant business must either pay sufficient W-2 wages or else own sufficient tangible depreciable property.¹¹⁷ For businesses that do not already meet one of these tests, the obvious game is to seek to obtain more tangible depreciable property.

However, if obtaining more property would be profitable for the business absent tax motivations, then presumably the business would have already done so even without the new tax incentives created by the pass-through deduction rules. Thus, the concern here is that the pass-through deduction rules incentivize taxpayers to effectively burn money in order to unprofitably obtain more tangible depreciable property that would otherwise function better in another business.

For example,¹¹⁸ assume that a pass-through business has no employees, and therefore no W-2 wages. Further assume that the business buys a debt-financed asset for \$10,000, with zero cash out of pocket. Finally assume that the asset earns a six percent rate of return, but that the business pays 7% annual interest on the debt.

Absent tax considerations, this would be a net money loser. This is because the interest payment exceeds the rate of return, generating a 1% or \$100 net economic loss. Under the new pass-

115. Prop. Treas. Reg. § 1.199A-5(b)(2)(vi), 83 Fed. Reg. 40,884, 40,924 (Aug. 16, 2018).

116. Prop. Treas. Reg. § 1.199A-5(b)(2)(vii), 83 Fed. Reg. 40,884, 40,924 (Aug. 16, 2018).

117. I.R.C. § 199A(b)(2) (2017).

118. This example builds on analysis in a prior blog post written by one of us (Shaviro). See Daniel Shaviro, *Under the New Tax Bill, Lose Money Before Tax but Make Money After-Tax*, START MAKING SENSE (Dec. 17, 2017, 3:03 PM), <http://www.danshaviro.blogspot.com/2017/12/under-new-tax-bill-lose-money-before.html>.

through deduction rules, however, the business can apply 2.5% of the cost of new asset (\$250) towards increasing the pass-through deduction,¹¹⁹ thereby reducing the business's taxable income by \$350 per year (when added to the net \$100 interest expense). At a 37% tax rate, this deduction would thus reduce the taxpayer's final tax liability by approximately \$130, which is more than the \$100 economic loss from the money-losing investment.

As this example demonstrates, the new pass-through deduction rules will incentivize some taxpayers to effectively burn economic resources in order to make unprofitable investments in order to qualify for the pass-through deduction.

Furthermore, taxpayers will also be incentivized to obtain legal ownership of tangible depreciable property without obtaining meaningful economic ownership. For instance, a taxpayer could purchase tangible depreciable property owned by another party, then lease that property back to the original party with the terms written so that the original party maintains effective economic ownership, but with legal ownership transferring so as to enable the taxpayer to qualify for the pass-through deduction.

Sale and leaseback transactions of this sort have long been used as a tool for tax gaming.¹²⁰ Yet the rules governing the new pass-through deduction create further incentives for taxpayers to engage in these sorts of transactions.

Overall, we should expect for some taxpayers to burn economic resources in order to purchase property, and for more widespread tax gaming whereby taxpayers obtain legal ownership of property without economic ownership, with the result being magnified social costs from distortionary tax gaming.

B. REFORM POSSIBILITIES

The fundamental issue underlying all of the technical problems we explain in this Part is the lack of underlying logic in deciding who can benefit from the pass-through deduction and who cannot. Independent contractors and partners can benefit, but not employees. Why? An owner of real estate through a REIT can benefit, but not the doctor in the building. Why? An architect can benefit in some ways that a lawyer cannot. Why? And so on.

119. I.R.C. § 199A(b)(2)(B)(ii).

120. *E.g.*, JOSEPH BANKMAN ET AL., FEDERAL INCOME TAXATION ch. 8 (17th ed. 2017); MICHAEL A. LIVINGSTON & DAVID S. GAMAGE, TAXATION: LAW, PLANNING, AND POLICY 502–20 (2d ed. 2010).

For each of these formalistic and seemingly arbitrary distinctions, there is a game to be played to fall within the favored category. Treasury should limit these games to the extent possible, so as to staunch the bleed in revenue, and it has made an attempt with the proposed regulations. However, the IRS will face an uphill battle in combatting these games due to the incoherent nature of the statutory provision, and the narrow way in which it is so far defining an important restriction on the deduction for high-income service providers.

Given this provision's regressivity, expense, and complexity, the best reform solution would be to simply eliminate the pass-through deduction.

III. STATE GOVERNMENT RESPONSES TO THE SALT DEDUCTION CAP

One of the most controversial changes brought by the 2017 tax legislation is the new cap on the deduction for state and local tax (SALT) payments under section 164 of the Internal Revenue Code. This new cap limits individual taxpayers to claiming no more than \$10,000 in SALT deductions for tax years 2018 through 2025, but permits a combination of taxes in order to reach that cap.¹²¹ For example, a taxpayer could deduct both property and income taxes up to this combined amount.

Some taxpayers will now find themselves at or below the cap and thus not directly affected by the partial repeal of the SALT deduction. In many parts of the country, however, millions of taxpayers regularly pay state and local taxes well in excess of the \$10,000 cap.¹²² Furthermore, many of those taxpayers will see a net tax increase under the new law.¹²³ This is why the par-

121. I.R.C. § 164(b)(6)(B). The tax legislation also significantly increases the standard deduction, which will also reduce the number of taxpayers taking the SALT deduction. *Id.* § 63(c)(7).

122. Tracy Gordon, *The Price We Pay for Capping the SALT Deduction*, TAX POLY CTR.: TAXVOX (Feb. 15, 2018), <http://www.taxpolicycenter.org/taxvox/price-we-pay-capping-salt-deduction> (providing map of states with average SALT deduction over \$10,000).

123. See, e.g., CAL. FRANCHISE TAX BD., PRELIMINARY REPORT ON SPECIFIC PROVISIONS OF THE FEDERAL TAX CUTS AND JOBS ACT 12 (2018), <https://www.ftb.ca.gov/law/legis/Federal-Tax-Changes/CAPreliminaryReport3Provisions-Revise.pdf> (estimating that approximately 1,000,000 California taxpayers will be impacted by the SALT cap and will end up paying more than \$100 overall in increased taxes as a result of the new tax law).

tial repeal of the SALT deduction was projected to be a very significant revenue raiser, something on the order of \$500 billion over the budget window.¹²⁴

In this Part, we argue that it was incorrect to estimate that such a large amount of revenue could be raised from a slice of taxpayers in just a few states because those states' governments could and would respond by adjusting their tax systems.

Some additional clarifications are helpful before we survey some possible state government responses. First, it is worth noting that state government responses to the SALT deduction repeal are to some extent a different category of concern as compared to gaming by individual and business taxpayers. One reason for this is because, at least to some extent, our tax system is based on the expectation that different states will compete with one another through tax policy design for the benefit of each state's citizens. Indeed, on a broader level, inter-jurisdictional tax competition is one of the primary justifications for many of the business tax law changes the tax legislation enacts; the idea there being that the United States is trying to improve its competitive position as compared to other nations by means of tax reform. Thus, state governments have a different relationship with the federal government than do individual and business taxpayers. This different relationship arguably makes potential state government responses to the tax legislation different in kind from gaming responses by individual and business taxpayers.

Moreover, there is another, related reason why state government responses are arguably in a different category from other forms of gaming. This is because the size and nature of the partial repeal of the SALT deduction placed an enormous new burden on state governments that are trying to fund their public spending with progressive taxes.¹²⁵ Furthermore, these same state governments that are disproportionately burdened by the tax legislation are generally also trying to fund *more* social services than are many other states' governments.¹²⁶ Given that the highest marginal individual income tax rate pre-2018 was 39.6%, the SALT deduction repeal in effect raised the tax price of progressive state income taxes by almost 40% for taxpayers in the highest tax bracket—a huge change. This shock could have

124. COMM. OF CONFERENCE, 115TH CONG., JOINT EXPLANATORY STATEMENT OF THE COMM. OF CONFERENCE app. at 2 (2017).

125. See generally Hemel, *supra* note 9.

126. See Gordon, *supra* note 122.

been mitigated by a phase-in or by pairing this increase in tax price with additional federal funding for, say Medicaid, or through some other form of federal government support for state-level finances. Yet no such measures were enacted, and there is a reasonable expectation that the federal government will instead attempt to shift even more financial burdens onto state governments.¹²⁷ Accordingly, even for those who believe in the abstract that state governments ought not to tax income at progressive rates, one might still agree on federalism grounds that a state would have sound reasons to act so that its preferred tax policy—progressive income tax rates—can be sustained in the face of a sudden shift in federal policy.¹²⁸

Regardless, whatever the justification for state government responses and whether or not one might agree or disagree with these justifications,¹²⁹ our primary analytical point is that states have several plausible avenues to mitigate the large and sudden change created by the SALT deduction repeal, and there was and is every reason to expect state governments to take such actions.

In this regard, the SALT deduction repeal is very similar to other aspects of the tax legislation that we have highlighted. Just as the tax legislation's legislative process did not sufficiently take into account the likely consequences of taxpayer responses to other changes (like dramatically reducing the corporate tax rate), the legislative process also did not sufficiently take into account how state governments are likely to respond to the partial repeal of the SALT deduction.

127. For example, California estimated that it stood to lose over \$100 billion in federal funding under the Senate Obamacare repeal bill. Memorandum from the Cal. Dep't Health Care Servs. to Diana S. Dooley, Sec'y, Cal. Health & Human Servs. (June 27, 2017), http://www.dhcs.ca.gov/Documents/BCRA_Impact_Memo_062717.pdf.

128. Of course, this is also assuming that wealthier taxpayers respond to tax rates. Even if one is inclined to believe that the response of wealthy taxpayers has thus far been more muted than anecdotally reported, there would still be good reason for states to avoid conducting such a high stakes natural experiment. For a conservative estimate of the responsiveness of the wealthy to tax rates, see Cristobal Young et al., *Millionaire Migration and Taxation of the Elite: Evidence from Administrative Data*, 81 AM. SOC. REV. 421 (2016).

129. For critiques see, for example, Leonard E. Burman & Frank Sammartino, *State Responses to the TCJA's SALT Deduction Limit May Be Costly and Favor High-Income Residents*, TAX POL'Y CTR.: TAXVOX (Jan. 30, 2018), <http://www.taxpolicycenter.org/taxvox/state-responses-tcjas-salt-deduction-limit-may-be-costly-and-favor-high-income-residents>; Jared Walczak, *State Strategies to Preserve SALT Deductions for High-Income Taxpayers: Will They Work?*, TAX FOUND. (Jan. 5, 2018), <https://taxfoundation.org/state-strategies-preserve-state-and-local-tax-deduction>.

At the time of this writing, there remains considerable uncertainty about what actions state governments will actually take and about how the IRS, Treasury, and courts might respond. However, each of the expedients outlined below has already been enacted into law by at least one state and all of these expedients are in active consideration by other state governments.

All three expedients look to continue to fund state and local governments using dollars that are still deductible at the federal level. The first expedient discussed, in Section A, will be the increased use of charitable deductions because the new tax law did not change the rules governing charitable donations to governments. Section B will discuss states shifting to the greater use of a payroll tax imposed on an employer; the new tax law did not change the rules governing the deductibility of taxes imposed on a business. Section C will consider shifting to a different kind of tax imposed on business entities; such taxes also remain deductible. Finally, in Section D, we briefly consider other more thoughtful approaches to reforming the SALT deduction.

A. INCREASED USE OF CHARITABLE GIFTS

The tax legislation did not change the prior tax law provisions allowing taxpayers who itemize to deduct charitable contributions, including for charitable contributions to state and local governments.¹³⁰ The tax legislation also did not address the broad ways that federal tax law has treated charitable donations to governments, which has been to ignore the state and local tax consequences in valuing a charitable gift for purposes of the federal-level deduction.¹³¹ Even when the highest marginal tax rate was 91%, in 1963,¹³² federal tax law did not reduce the value of an individual's federal deduction for charitable contributions on

130. I.R.C. § 170(e)(1) (2017).

131. The analysis in Part III.A overlaps substantially with analysis from two other essays. Joseph Bankman et al., *Caveat IRS: Problems With Abandoning the Full Deduction Rule*, 88 ST. TAX NOTES 547 (2018); Joseph Bankman et al., *State Responses to Federal Tax Reform: Charitable Tax Credits*, 83 ST. TAX NOTES 433 (2018) [hereinafter *State Responses*]. Four of the authors of this article are also co-authors of those (contemporaneously written) essays, which elaborate on much of the analysis in Part III.A in greater depth than we can here.

132. *Historical Highest Marginal Income Tax Rates*, TAX POL'Y CTR. (Mar. 22, 2017), <http://www.taxpolicycenter.org/statistics/historical-highest-marginal-income-tax-rates>.

account of federal or state-level tax benefits received from making charitable contributions.

Moreover, this principle—which has been called the “full deduction rule”—has also been applied in reference to state-level tax credits offered to subsidize taxpayers for making certain kinds of desired donations.¹³³ These state-level tax credits have been quite generous in some cases, sometimes as high as 100%.¹³⁴ Relying on longstanding precedents governing the treatment of charitable deductions, both courts and the IRS have consistently applied the full deduction rule to these state-level tax credits. This means that even for taxpayers receiving a 100% state-level tax credit, federal tax law has not reduced the value of the federal-level charitable contribution deduction allowed on account of that state-level tax benefit.

Consequently, for state-level tax credits of somewhat less than 100%, taxpayers may achieve more than a dollar of combined state and federal tax savings for each dollar contributed.

Note here that a 90% (or lower) credit would still enable participants to come out ahead after tax for making a qualifying donation. If a taxpayer in the new 24% federal income tax bracket were to make a \$100 qualifying charitable contribution through such a program, he would save \$90 of state-level taxes and \$24 of federal level taxes. The full after-tax return would thus be \$114 of combined tax savings from the \$100 contribution.

Thus, by offering more expansive state-level charitable contribution credits for donations to state governments or to state-government sponsored programs, state governments can effectively facilitate taxpayers transforming (potentially federally non-deductible) state tax payments into (federally deductible) charitable contributions.

We are aware of over 100 programs in thirty states that already had generous credits of this type in place prior to the passage of the new tax legislation.¹³⁵ Furthermore, prior to the recent partial cap on the SALT deduction enacted by the new tax legislation, millions of taxpayers who had been subject to the federal Alternative Minimum Tax (AMT) were in a situation where they lost their SALT deductions as a result of being subject to

133. *State Responses*, *supra* note 131 (detailing how the “full deduction” rule can be used by taxpayers).

134. *Id.* at 433.

135. *Id.*

the AMT.¹³⁶ These taxpayers nevertheless retained their eligibility for federal charitable contribution deductions made as part of these generous state-level credit programs.

In other words, even prior to the new tax legislation, the combination of the previously existing state-level credit programs and the limits on federal SALT deductions due to the AMT meant that a good number of taxpayers could effectively transform at least portions of their (non-federally deductible on account of the AMT) state tax liabilities into (fully federally deductible) charitable contributions.

The more stringent limitations on SALT deductions enacted through the tax legislation thus put more—or somewhat different—taxpayers into an equivalent situation that had already been faced by many taxpayers subject to the AMT.¹³⁷ Consequently, we predicted that state governments would explore expanding their use of state-level tax credits for charitable contributions to particular activities, facilitating a greater number of taxpayers taking advantage of the opportunity that federal tax law has allowed for transforming (non-federally deductible) state tax liabilities into (federally deductible) charitable contributions.

Indeed, perhaps because this basic structure for using tax credits to mitigate the tax legislation's partial denial of SALT deductibility was already widespread prior to the tax legislation, this has been the strategy for state responses that has drawn the most attention of state legislators and commentators.¹³⁸ For instance, New York passed a law that provides an 85% credit for

136. I.R.C. § 56(b)(1)(A)(ii) (2017); Frank Sammartino, *The Complex Relationship Between the State and Local Tax Deduction and the Alternative Minimum Tax*, TAXVOX: TAX POL'Y CTR. (June 19, 2017), <https://www.taxpolicycenter.org/taxvox/complex-relationship-between-state-and-local-tax-deduction-and-alternative-minimum-tax>.

137. The IRS proposed regulations report that about 5% of taxpayers are expected to be itemizers with state and local taxes over the SALT cap. Contributions in Exchange for State or Local Tax Credits, Prop. Treas. Reg. § 1.164(b)(6), 83 Fed. Reg. 43,563, 43,569 (Aug. 27, 2018) (to be codified at 26 C.F.R. pt. 1). The Tax Policy Center reported that about 5% of taxpayers were subject to the AMT in 2017. *T17-0149: Characteristics of Alternative Minimum Tax (AMT) Payers, 2016 - 2018 and 2027*, TAX POL'Y CTR. (Apr. 28, 2017), <https://www.taxpolicycenter.org/model-estimates/baseline-alternative-minimum-tax-amt-tables-april-2017/t17-0149-characteristics>. Thus, the tax legislation might not have even placed many more taxpayers into the position of having a capped (or zero) deduction for state and local taxes.

138. *E.g.*, Contributions in Exchange for State or Local Tax Credits, Prop. Treas. Reg. § 1.164(b)(6), 83 Fed. Reg. 40,884, 43,563 (Aug. 16, 2018); Walczak, *supra* note 129.

donations to one of two charitable funds.¹³⁹ At the time of this writing, California is considering two such laws. One of these proposals would, in effect, permit an 80% credit for a donation to almost any 501(c)(3).¹⁴⁰

It is currently too early to foretell the fate of these efforts. It remains to be seen to what extent these new programs might survive possible efforts by Treasury or the IRS to restrict them.¹⁴¹ On August 27th, the Treasury Department and the IRS promulgated proposed regulations targeting state-credit programs in particular.¹⁴² The upshot of these regulations is that the IRS will henceforth reduce the value of a charitable donation at the federal level by the value of state-level credits if those credits exceed 15%. Such a rule forecloses using charitable donations as a SALT workaround, but has no impact on the other two workaround strategies we discuss. At the time of this writing, the future of these regulations is unknown. If the regulations are finalized as written, we think they will be hard to challenge, though they are hardly unassailable.¹⁴³

Yet there is also a reasonable chance the regulations will be changed in a way that makes them more susceptible to challenge. Powerful parties have urged the IRS to carve out exceptions for at least some of the credit programs that pre-existed the TCJA.¹⁴⁴ There are various ways the carve outs could be done, including relying on some form of the public/private distinction.¹⁴⁵ If the final regulations move from a relatively principled position about all state-level credits, we would expect challenges to the regulations to be more powerful.

139. N.Y. STATE FIN. LAW § 92-GG.4; N.Y. TAX LAW § 606(iii) (Consol. 2018).

140. Assemb. B. 2217, 2017–18 Leg. (Cal. 2018).

141. For further discussion, see David Gamage, *Charitable Contributions in Lieu of SALT Deductions*, 87 ST. TAX NOTES 973, 974–75 (2018) (discussing whether Treasury has the authority to revise this aspect of federal tax law without legislation).

142. See Contributions in Exchange for State or Local Tax Credits, 83 Fed. Reg. at 43,563.

143. See, e.g., Daniel Hemel, *Pounding SALT?*, MEDIUM: WHATEVER SOURCE DERIVED (Aug. 27, 2018), <https://medium.com/whatever-source-derived/pounding-salt-f37b5e22def4>.

144. Amy Hamilton, *IRS Has Plan to Shut Down SALT Workarounds*, TAX PRAC. EXPERT, at 21 (2018) (“[Kevin] Brady . . . encouraged states with pre-TCJA tax credit programs in place to review the proposed regulations ‘and make full use of the comment period.’”); The Editorial Bd., *Blue State ‘Charity’*, WALL ST. J. (Aug. 17, 2018), <https://www.wsj.com/articles/blue-state-charity-1534546826>.

145. See, e.g., Amandeep Grewal, *The Charitable Contribution Strategy: An Ineffective SALT Substitute*, 38 VA. TAX REV. (forthcoming 2018).

In any event, we highlight the credit response by state governments not because we view this response as ideal or impervious to regulatory action, but instead to note that the arguments these responses rely upon are substantial and are thus an example of a possible game (or perhaps glitch) that could have—and should have—been considered as part of the legislative process leading up to the tax legislation. Indeed, the current legal uncertainty surrounding the fate of these programs is in itself another harm caused by the rushed process of drafting and passing the tax legislation.

B. INCREASED USE OF PAYROLL TAXES

A fundamental rule of tax administration is that tax law follows legal incidence, not economic incidence.¹⁴⁶ The legal incidence of a payroll tax falls on an employer to the extent that the employer has payroll.¹⁴⁷ By contrast, the consensus among economists is that a large portion of the payroll taxes currently levied are actually paid by employees—that is, the economic incidence is different from the legal incidence.¹⁴⁸

Taxes imposed on employers as an ordinary and necessary business expense remain deductible following the tax legislation.¹⁴⁹ This asymmetry thus suggests another strategy for state government responses: shifting from income taxes to payroll taxes.¹⁵⁰

States already have payroll levies in place for unemployment taxes. All that would be required to implement this response is for a state government to legislate an increase in its payroll tax levies accompanied by either roughly offsetting decreases to its income tax levies or else the provision of income tax credits to offset the new payroll tax levies.

146. See, e.g., *Fulton Corp. v. Faulkner*, 516 U.S. 325, 341 (1996) (discussing the Supreme Court's reluctance to look through legal incidence to economic incidence).

147. Don Fullerton & Gilbert E. Metcalf, *Tax Incidence*, in 4 HANDBOOK OF PUBLIC ECONOMICS 1787, 1789 (Alan J. Auerbach & Martin Feldstein eds., 2002).

148. *Id.* at 1821–22.

149. I.R.C. § 162(a) (2017).

150. For earlier discussion of this strategy by one of us, see Daniel Hemel, *State Payroll Tax Shift Stands on Solid Legal Ground*, MEDIUM: WHATEVER SOURCE DERIVED (Jan. 5, 2018), <https://medium.com/whatever-source-derived/state-payroll-tax-shift-stands-on-solid-legal-ground-fe769d8ab309>.

Of course, there are a host of administrative concerns related to implementing such a response.¹⁵¹ Among these, the structure of this response requires that employees bear the tax through decreased (after-payroll-tax) salaries.¹⁵² The employees are then made whole by the reduction in their income tax liabilities. But will salaries actually adjust? In some cases, full and immediate adjustment might not happen because of locked-in contract terms.

Another administrative concern is that payroll taxes are a flat levy and so maintaining the overall state tax system's progressivity following the implementation of this response can be complicated. Further, many taxpayers who itemize earn significant income from sources other than salary and thus a payroll tax shift does not mitigate the SALT cap as to taxes on that income.¹⁵³

Yet, these administrative concerns do not appear to be insurmountable. For instance, New York has enacted a program of this sort while making the program elective and only for employees with higher salaries.¹⁵⁴

Notably, in addition to being a response to the new cap on federal SALT deductions, payroll tax has other (controversial) policy justifications. On the negative side of the ledger, payroll taxes are regressive and impose a tax on an activity we generally want employers to do more of (paying wages), which are two big strikes against payroll taxes. Yet payroll taxes provide a broad and stable tax base that one can use to finance social welfare programs, which is currently done in the United States and in other jurisdictions all over the world.¹⁵⁵ Thus, although this policy expedient is primarily reactive, it is important to keep in mind that the payroll tax response strategy has its own *arguably* positive justifications.

151. For discussion, see Brian Galle, *State SALT Fixes, Part III: Payroll Tax & Credit*, MEDIUM: WHATEVER SOURCE DERIVED (Jan. 4, 2018), <https://medium.com/whatever-source-derived/state-salt-fixes-part-iii-payroll-taxcredit-c2031d7b3caa>.

152. *Id.*

153. *Id.*

154. N.Y. TAX LAW §§ 850–57 (Consol. 2018).

155. See generally KYLE POMERLAU, TAX FOUND., FISCAL FACT NO. 434, A COMPARISON OF THE TAX BURDEN ON LABOR IN THE OECD (2014) (comparing payroll taxes worldwide).

C. INCREASED TAXATION OF PASS-THROUGH BUSINESSES

Increased use of payroll taxes is not the only way for states to take advantage of the continued federal deductibility of taxes imposed on businesses. Another possible response relies on the fact that many of the taxpayers who are going to be impacted by the SALT deduction repeal are receiving some or all of their income through a pass-through entity. Thus, a similar strategy to the payroll tax response should work to restore federal SALT deductibility for these taxpayers: increase state taxes on pass-through entities while correspondingly reducing these taxes through the provision of offsetting individual-level tax credits.¹⁵⁶ To offset the increased pass-through-level taxes, individual tax credits could be offered equal to the amounts paid as new taxes by pass-through entities (as allocated to individual taxpayers). Notably, Connecticut has already passed a tax with this structure.¹⁵⁷

There are two primary legal challenges posed by this approach. First, as with the payroll tax strategy, there is the question of whether the credit given to individual taxpayers should equal 100% of the increased pass-through-level taxes paid. A credit of less than 100% is likely to be stronger in the face of possible efforts by the IRS to restrict this strategy on substance-over-form grounds.¹⁵⁸

The second challenge relates to the base of the new tax. Suppose the entity-level tax is imposed on the capital stock of the business. This kind of tax is clearly imposed on the business and should be deductible under current federal law. However, what if the tax imposed on the entity is considered an income tax? Now the matter becomes a little trickier.

As written, new section 164(b)(6) of the Internal Revenue Code operates in two steps: First, the new provision limits the aggregate deduction for state and local taxes to \$10,000.¹⁵⁹ Income taxes clearly count toward this limit.¹⁶⁰ Second, the new provision explicitly permits deductions beyond the \$10,000 cap if they “are paid or accrued in carrying on a trade or business or an activity described in section 212.”¹⁶¹ So, this second step

156. *E.g.*, 2018 Conn. Acts 18-49 (Reg. Sess.) (codified in scattered sections of CONN. GEN. STAT. tit. 12 (2018)).

157. *Id.*

158. *See supra* notes 146–50 and accompanying text.

159. I.R.C. § 164(b)(6)(B) (2017).

160. *Id.* § 164(a)(3).

161. *Id.* § 164(b)(6).

makes it clear that taxes on businesses remain deductible, but the provision only lists real and personal property taxes and excludes income taxes.¹⁶² Taken to the limit, this omission of income taxes could suggest that even corporations can no longer deduct their state-level corporate income tax payments.

Yet there are several indications in the legislative history that this is *not* what Congress intended. For instance, the conference report explains that “[u]nder the provision, in the case of an *individual*, State and local income, war profits, and excess profits taxes are not allowable as a deduction.”¹⁶³ A footnote further adds that:

The proposal does not modify the deductibility of GST tax imposed on certain income distributions. Additionally, taxes imposed at the entity level, such as a business tax imposed on pass-through entities, that are reflected in a partner’s or S corporation shareholder’s distributive or pro-rata share of income or loss on a Schedule K-1 (or similar form), will continue to reduce such partner’s or shareholder’s distributive or pro-rata share of income as under present law.¹⁶⁴

Moreover, the interpretation that income taxes imposed on a business entity remain deductible makes sense more generally given the role of section 164. This is because section 164 provides a deduction to individuals whereas businesses—and other profit-making enterprise—can deduct their tax payments under sections 162 and 62 without the need for section 164. An exclusion from section 164 should thus not be interpreted as denying a deduction that is not granted by section 164, but instead is granted by sections 162 and 62.

Despite this logic, there remains legal uncertainty on account of new section 164 targeting income taxes in particular and not permitting an exception if the income tax is accrued in connection with carrying on a trade or business. Presumably the intent here was to make sure that, say, a plumber who does business as a sole proprietor cannot deduct her income taxes any more than a plumber who is employed by someone else.¹⁶⁵ At the

162. *Id.*

163. COMM. OF CONFERENCE, 115TH CONG., JOINT EXPLANATORY STATEMENT OF THE COMM. OF CONFERENCE 81 (2017) (emphasis added).

164. *Id.* at 80 n.172.

165. For some discussion of these issues as they played out, see David Kamin, *State and Local Income Tax Deduction: Some Answers, More Questions*, MEDIUM: WHATEVER SOURCE DERIVED (Nov. 15, 2017), <https://medium.com/whatever-source-derived/state-and-local-income-tax-deduction-some-answers-more-questions-6a7737498921>.

same time, the self-employed plumber should be able to deduct the cost of property taxes levied on her place of business.¹⁶⁶

But what about the partner in a law firm if a tax is levied at the firm level? If the tax is a “business tax,” say a tax on the capital stock of the business or its payroll, then there seems to be no issue—it remains deductible. But what if the firm level tax is an income tax? This is the question that remains legally uncertain. Thus, any state implementing the increased pass-through taxation response strategy should give careful thought to these legal and design questions. With appropriate design, it seems clear that state governments can implement this strategy while remaining safely on the deductible side of the line.¹⁶⁷

Finally, it is worth noting that there are at least three policy justifications that could support a state adopting this strategy, beyond the goal of circumventing the new federal-level cap on SALT deductibility. First, as one of us has argued elsewhere, there are compelling reasons (apart from any considerations related to the new SALT deduction cap) for state governments to impose new taxes on pass-through entities.¹⁶⁸ The essence of this argument is that the new federal pass-through deduction creates a host of incentives for taxpayers to recharacterize themselves as qualifying pass-through businesses,¹⁶⁹ in addition to this new deduction making for questionable tax policy even without these distortionary gaming incentives.¹⁷⁰ New state-level taxes on pass-through entities could thus counteract some of the harms created by the federal pass-through deduction by reducing or eliminating the unwarranted tax benefits provided.¹⁷¹

The second policy justification arises from the longstanding problem that state revenue systems have taxed corporations at the entity level but not other forms of businesses. The primary reason why this has been the case is because of the administra-

166. I.R.C. § 164(b)(6).

167. For instance, one way to do this is to have the tax base calculated based on the worth of business-level property rather than based on business-level income.

168. See Darien Shanske, *Another Way the Empire [State] Can Strike Back*, MEDIUM: WHATEVER SOURCE DERIVED (Jan. 4, 2018), <https://medium.com/whatever-source-derived/another-way-the-empire-state-can-strike-back-465d6496e928> (discussing progressivity, administrability, and efficiency).

169. See *supra* Part II.

170. See Shaviro, *supra* note 73, at 66–67 (describing the 2017 Act as “an ugly stain on the fabric of the U.S. federal income tax law”).

171. Shanske, *supra* note 168.

tive and other benefits state governments can achieve by piggy-backing on the federal-level corporate income tax.¹⁷² However, given the rising importance of pass-through entities, it has become increasingly problematic on policy grounds that state governments disproportionately impose additional tax burdens only on corporations and not on pass-through business entities.¹⁷³ Accordingly, state governments should arguably implement new taxes on pass-through entities even apart from any considerations related to the federal SALT deduction.

The third and final policy justification relates to how expanding state-level taxation to all business entities *could* help improve state tax systems in other ways. For instance, it is commonly observed that states typically tax an ever narrower part of the consumption tax base with retail sales taxes, because states primarily tax the sales of tangible personal property and not, for example, services.¹⁷⁴ Yet on the other side of every consumption transaction is a business, and so an appropriately designed tax on businesses can serve to improve the overall taxation of consumption transactions within a state.¹⁷⁵ There is much more that could be said about this policy justification, and, of course, the implementation details are of crucial importance. However, our point here is that there are defensible policy justifications for new state-level business taxes that could serve as partial end runs around the new federal SALT deductibility cap and that these justifications would arguably support implementing these new state-level taxes even apart from any considerations related to the federal SALT deduction cap.

D. REFORM POSSIBILITIES

As with the section 199A deduction, the fundamental problem with the capping of the SALT deduction is that it was not based on a coherent principle.¹⁷⁶ This lack of principle provides

172. David Gamage & Darien Shanske, *Tax Cannibalization and Fiscal Federalism in the United States*, 111 NW. U. L. REV. 295, 337–38 (2017).

173. *Id.* at 319–25, 352–53.

174. *Id.* at 364–65.

175. For discussion of one such structure—that of New Hampshire’s Business Enterprise Tax—see *id.* at 350–52.

176. For further elaboration, see David Gamage & Darien Shanske, *The Future of SALT: A Broader Picture*, 88 ST. TAX NOTES 1275, 1275 (2018) (“[T]hese changes are not consistent with any theory”); see also Daniel Jacob Hemel, *The Death and Life of the State and Local Tax Deduction*, 72 TAX L. REV. (forthcoming 2019).

both the means and the rationale for the efforts currently underway in some states to circumvent the new cap.¹⁷⁷ We will conclude by briefly considering other reform options to illustrate these points.

It is true that capping the SALT deduction is a progressive change made by the new law, but the overall law is highly regressive and so progressivity is an incongruous justification for the change to the SALT deduction. Moreover, capping the SALT deduction has the effect of making it more difficult for states to fund themselves with progressive taxes.¹⁷⁸ In short, a principled progressive reform of the SALT deduction would either turn it into a credit in order to make it more widely available or would pair limiting the deduction with reducing the fiscal burden on the states so that the states would have less need to impose progressive taxes.

Alternatively, one might argue that the SALT deduction was always too generous, that on income tax principles at least some portion of state and local taxes represents a consumption choice and should not be deductible.¹⁷⁹ Yet that theory hardly justifies setting an arbitrary \$10,000 cap. Instead, that theory would be more consonant with limiting the SALT deduction to some percentage of state and local taxes, say 50%, phased in over time.

As a final alternative, the federal government might want to influence the tax mix used by the states. There are potentially good reasons for this motive, including the goals of increasing state fiscal stability by encouraging use of the property taxes, or of discouraging the use of the state corporate income tax because of the disruption that tax causes to interstate businesses.¹⁸⁰ Both of these goals could be achieved through revision of the SALT deduction.

But the new SALT cap was not designed in a manner that would promote any of these, arguably, valid goals, nor even a plausible mix of such goals.¹⁸¹ This lack of principle invites state governments to enact workarounds, as does capping the SALT deduction but not capping substitutes like the charitable deduction.¹⁸² Moreover, whatever the ultimate fate of the state government workarounds that have already been enacted and that are

177. See *supra* Parts III.A–C.

178. See *supra* note 125 and accompanying text.

179. See Gamage & Shanske, *supra* note 176.

180. *Id.*

181. *Id.*

182. David Kamin, *Sustainable Solutions for SALT*, MEDIUM: WHATEVER

currently being considered, we think it inevitable that—absent future federal legislation—a substantial amount of state government workaround attempts will eventually succeed.¹⁸³ After all, it is clearly permitted for state governments to, for instance, simply swap toward greater use of corporate income taxes in place of capped individual level taxes.¹⁸⁴

Overall, in contrast to section 199A, which would be best reformed by being eliminated, there are valid arguments favoring reform of the SALT deduction. A better designed SALT deduction cap might well be preferable to restoring the SALT deduction to the status it held in 2017, especially if enacting this new, better-designed cap were accompanied by further principled reforms. Again, the essential problems with how the tax legislation capped the SALT deduction arise from the unprincipled nature and hasty enactment of this cap.¹⁸⁵

IV. INTERNATIONAL GAMES, ROADBLOCKS, AND GLITCHES

The new tax legislation's international tax provisions are among the most complex of the changes made by the new tax legislation. These reforms deserve serious attention and, as illustrated below, present numerous gaming opportunities, adverse consequences under international law, and undesirable incentives to locate investment and assets abroad.

To be sure, the old system of U.S. international tax rules, prior to the new tax legislation, was also the subject of considerable tax gaming and inefficiency. As measured against the baseline of old law, some of the new rules represent modest improvements. However, these new rules fare worse when judged against a normatively ideal system. They also, overall, fare poorly in solving problems in the old regime.¹⁸⁶ Regardless, our

SOURCE DERIVED (May 22, 2018), <https://medium.com/whatever-source-derived/sustainable-solutions-for-salt-1adeb5c89890>.

183. *Id.*

184. *See supra* Part III.C.

185. *See Shaviro, supra* note 73.

186. The Congressional Budget Office (CBO) estimates that nearly 80% of profit shifting is maintained under the new regime. CONG. BUDGET OFFICE, THE BUDGET AND ECONOMIC OUTLOOK: 2018 TO 2028, at 124, 127 (2018), <https://www.cbo.gov/system/files/115th-congress-2017-2018/reports/53651-outlook.pdf>. The effect on profit shifting is likely even smaller, however, since the CBO does not take into account investor reactions to the instability of the foreign derived intangible income (FDII) regime in response to World Trade Organization (WTO) challenges, investor reactions to the political instability of the legislation in general, and tax competition from other countries. *See* discussion

primary purpose here is to explain how the new system of rules created by the tax legislation will introduce problems that should be addressed either through regulation or further legislation.

By way of background, the basic structure of the new tax legislation's international reforms is to: (1) exempt foreign income of certain U.S. corporations from taxation in the United States (the quasi-territorial or participation-exemption system); (2) backstop this new territorial system with a 10.5% "minimum tax" on certain foreign-source income (the GILTI regime); (3) provide a special low rate on export income (the FDII regime); and (4) target profit-stripping by U.S. firms making deductible payments to foreign affiliates (the BEAT regime).¹⁸⁷

In the remainder of this Part, we discuss selected technical problems within the latter three of these new regimes, in turn.¹⁸⁸

infra Part IV.B.

187. See generally COMM. OF CONFERENCE, 115TH CONG., JOINT EXPLANATORY STATEMENT OF THE COMM. OF CONFERENCE 429–65 (2017) (discussing changes to international tax provisions). The new regime maintains the subpart F rules, which tax currently at the regular 21% domestic rate foreign passive income and base income. I.R.C. §§ 951–65 (2017) (incorporating section 11 domestic taxation rate). Indeed, the new legislation strengthened subpart F, albeit in a minor fashion, by expanding the definition of a U.S. shareholder. *Id.* § 951(b). Good tax planning, including use of check-the-box rules, however, means that Subpart F stands as more of a sieve than a barrier to profit shifting. See, e.g., Lawrence Lokken, *Whatever Happened to Subpart F? U.S. CFC Legislation After the Check-the-Box Regulations*, 7 FLA. TAX REV. 185, 196–99 (2005) (discussing the use of hybrid entities to defeat subpart F).

Indeed, the new legislation opens up sheltering opportunities using the subpart F rules. Suppose, for instance, a wealthy individual has no need for cash and wants to invest in bonds or in an equity trading strategy. She forms a corporation in a tax haven, contributes the cash to the corporation, and directs it to make the investments. Under section 962, an individual U.S. shareholder of a controlled foreign corporation can elect to be taxed on subpart F income at the corporate tax rate. Although a second tax is imposed on distributions, an individual can avoid that level of tax by not having the corporation distribute income. Upon her death, the heirs will get a stepped-up basis, per operation of section 1014, and can sell the corporation free of all tax, assuming the corporation is sold to a foreigner. Additionally, the personal holding company rules, sections 541–47, do not apply to foreign corporations, and the accumulated earnings tax rules, sections 531–37, allow for a deduction for subpart F income. I.R.C. § 535(b)(10). Effectively, the section 962 election allows for a better investment vehicle than a domestic C corporation because the controlled foreign corporation (CFC) is not subject to the personal holding company or accumulated tax regimes and upon death, a foreign purchaser is not subject to any latent U.S. tax liability. Thanks to David Miller for this point. See also Lee A. Sheppard, *Private Investment Funds and the TCJA*, 159 TAX NOTES 1397, 1400 (2018).

188. For additional views on the regime by individual authors of this Article,

A. PROBLEMS WITH THE GILTI REGIME

The new tax legislation imposes a minimum tax on “global intangible low-taxed income” (GILTI) of controlled foreign corporations,¹⁸⁹ which is intended to stop U.S. corporations from shifting profits out of the United States.¹⁹⁰ Specifically, GILTI imposes current tax at the regular domestic rate on certain earnings of such corporations and then effectively provides a reduced minimum tax rate of 10.5% through a 50% deduction.¹⁹¹ The need for an anti-abuse regime like GILTI partially arises because the new tax legislation’s switch from a worldwide system (whereby the income of foreign subsidiaries earned abroad was merely deferred) to a territorial system (whereby this income is exempted altogether) would exacerbate profit shifting.¹⁹²

However, the new GILTI regime, as structured, is highly problematic. This is due to the offshoring incentives that are created by the regime as well as the fact that it is applied on a global, rather than per-country basis, as discussed below.¹⁹³

1. Implications of a Global Minimum Tax

The new tax legislation allows foreign tax credits on a global basis (rather than per-country).¹⁹⁴ Firms are therefore incentivized to locate investment in low-tax countries and blend that income with income from high-tax countries.

see *Early Impressions of New Tax Law Before the S. Comm. on Fin.*, 115th Cong. (2018) (statement of Rebecca M. Kysar, Professor of Law, Brooklyn Law School), <https://www.finance.senate.gov/imo/media/doc/24APR2018KysarSTMNT.pdf>; Daniel N. Shaviro, *The New Non-Territorial U.S. International Tax System, Part 1*, 160 TAX NOTES 57 (2018) [hereinafter Shaviro *Part 1*]; Daniel N. Shaviro, *The New Non-Territorial U.S. International Tax System, Part 2*, 160 TAX NOTES 171 (2018) [hereinafter Shaviro *Part 2*].

189. Controlled foreign corporations are those foreign corporations in which more than 50% of the stock is owned by U.S. shareholders owning at least 10% of the corporation. I.R.C. § 957(a).

190. *Id.* § 951A.

191. *Id.* §§ 250(a)(1)(B), 951A. For tax years beginning after 2025, the 50% deduction is reduced to 37.5%, and thus the effective rate on GILTI goes up to 13.125% in those years. *Id.* § 250(a)(3).

192. N.Y. STATE BAR ASS’N TAX SECTION, REPORT NO. 1394, REPORT ON THE GILTI PROVISIONS OF THE CODE 15–17 (2018), http://www.nysba.org/Sections/Tax/Tax_Section_Reports/Tax_Section_Reports_2018/1394_Report.html.

193. We focus on the larger policy problems posed by GILTI. For a detailed account of the technical issues presented by GILTI, see generally *id.* (including discussions and recommendations for changes to the GILTI provisions).

194. I.R.C. § 951A(a).

For instance, say a corporation earns \$1,000,000 of income in Country A, which is taxed locally at a 21% rate. Further assume that there are no real assets abroad, so that the GILTI hurdle rate of 10% (discussed *infra*) does not apply. Further assume that the corporation is choosing where to locate an additional \$2,000,000 in profits (and any associated activity), with the choice being between the United States and a tax haven.¹⁹⁵

There would be a \$210,000 Country A tax and a tentative U.S. GILTI tax on this Country A income of \$105,000 (\$1,000,000 x 10.5%). The firm would, however, get to credit 80% of the \$210,000 Country A tax, reducing the U.S. tax to zero.¹⁹⁶ This would leave \$63,000 of excess foreign tax credits (\$105,000 – [\$210,000 x .8] = -\$63,000) that are lost forever under the GILTI rules.

If an additional \$2,000,000 were earned in the United States, the 21% U.S. tax thereon would be \$420,000 and the \$63,000 of excess credit for Country A tax could not be used to reduce this liability. Thus, the corporation's total tax liability (both U.S. and foreign) would be \$630,000 (\$210,000 Country A tax + \$0 post-credit U.S. tax on the first \$1,000,000 of Country A income + \$420,000 U.S. tax on the additional \$2,000,000 of U.S. income).

195. This example does not take into account the section 78 grossup or the possible allocation of expenses under the preexisting regulations for section 961 that could reduce allowable foreign tax credits perhaps contrary to congressional intent. Martin A. Sullivan, *More GILTI Than You Thought*, 158 TAX NOTES 845, 848–49 (2018). The expense allocation could have a large effect on the amount of tax owed under GILTI. *Id.* A host of other taxpayer unfriendly problems exist in the GILTI regime, which others have explored. Assets in CFCs that generate losses are disregarded for purposes of calculating the deemed return on tangible property. *Id.* at 847–48. Additionally, non-C-corporation shareholders may be unable to take foreign tax credits against liability for GILTI (unless they make an election under section 962). *Id.* at 846; see Sandra P. McGill et al., *GILTI Rules Particularly Onerous for Non-C Corporation CFC Shareholders*, MCDERMOTT WILL & EMERY: THOUGHT LEADERSHIP (Jan. 30, 2018), <https://www.mwe.com/en/thought-leadership/publications/2018/01/gilti-rules-particularly-onerous-nonc-corporation>. Under current law, GILTI deductions in excess of income are permanently disallowed and cannot create net operating losses (NOLs). I.R.C. § 250(a)(2)(B). Similarly, multinationals cannot carryover excess credits within the GILTI basket to future years. See Sullivan, *supra*, at 846. Both of these provisions burden businesses with volatile earnings, and may, like other loss limitations in the Code, distort investment away from risky assets. See Shaviro *Part 2, supra* note 188, at 181. These concerns, together with other issues such as the uncertainty over whether the foreign tax credit gross-up goes into the GILTI basket and questions over whether the GILTI should be a separate basket from branch income, will continue to challenge tax planners.

196. I.R.C. § 960(d).

Now assume the additional \$2,000,000 of income was instead earned in a tax haven, Country B, which taxes the income at a 0% rate. Looking at that investment on a standalone basis, this would produce \$210,000 of GILTI liability with no foreign tax credit offset. If the GILTI were applied on a per country basis, this would mean the company was paying \$210,000 foreign taxes on Country A income and \$210,000 of U.S. taxes on Country B GILTI, with total taxes of \$420,000.¹⁹⁷

Under current law, however, firms are able to cross-credit or blend low-income and high-income taxes together, thereby reducing their GILTI liability. Thus, under the current GILTI regime, the total foreign taxes imposed would be \$210,000 (imposed by Country A), 80% of which (\$168,000) is creditable against the 10.5% tax on the \$3,000,000 of total Country A and Country B GILTI. This produces a \$147,000 U.S. tax liability ($[10.5\% \times \$3,000,000] - 168,000$), with total foreign and U.S. taxes of \$357,000.

Why is the bill lower as compared to the per country approach? Because the \$63,000 excess credits from Country A partially offset the \$210,000 U.S. tax on Country B GILTI. This reduces the total tax liability (U.S. and foreign) to \$357,000 (as opposed to \$420,000 if we had a per country GILTI tax and \$630,000 if the investment were made in the United States).

In this manner, the global minimum tax enacted by the new tax legislation pushes countries towards investing abroad as opposed to the United States. Firms will attempt to create a stream of zero tax income that brings the average foreign taxes down to the minimum rate. Note that, through this blending technique, a firm can also shield profits in tax havens by choosing to invest in high-tax countries. A firm may even prefer to invest in countries with *higher* tax rates than the United States, since income and taxes from such countries can be used to blend down the U.S. minimum tax to zero.¹⁹⁸ This puts the United States at a com-

197. See Stephen E. Shay et al., *Designing a 21st Century Corporate Tax—An Advance U.S. Minimum Tax on Foreign Income and Other Measures to Protect the Base*, 17 FLA. TAX REV. 669, 706 (2015) (recommending that any minimum tax be determined on a per-country basis); see also J. Clifton Fleming Jr. et al., *Incorporating a Minimum Tax in a Territorial System*, 157 TAX NOTES 73, 80 (2017) (same).

198. For instance, if a firm already has tax haven income and is considering where to put a plant, assuming that the firm cannot locate the plant in a tax haven due to labor pool and/or legal environment considerations, it may well prefer a high-tax foreign country to the United States since the high-tax foreign

petitive disadvantage, making it more likely that jobs and investment go to countries like Sweden.

Troublingly, this feature worsens the dynamics discussed below that are created by the GILTI hurdle rate for offshore tangible assets. Critics of a per-country approach argue that it would be too complex administratively,¹⁹⁹ but the primary targets of the GILTI are sophisticated multinational corporations that can effectively deal with the challenge of computational complexity. Moreover, the blending technique itself requires significant resources and complex tax planning, and a global minimum tax would eliminate the need for such inefficient maneuvering.

Proponents of the global approach might argue that the per-country approach punishes multinationals that naturally conduct integrated production in high- and low-tax countries for non-tax reasons.²⁰⁰ The national welfare objective implicated in cross-crediting for non-tax purposes, however, may likely outweigh this concern.²⁰¹

2. The Deemed Ten Percent Return

The new tax legislation exempts from the GILTI minimum tax a deemed 10% return on tangible assets abroad, measured by tax basis.²⁰² Hence, this rule encourages U.S. firms to locate tangible assets (and accompanying jobs) overseas. This is because the more the corporation increases its U.S. tax basis in foreign assets abroad, the smaller the tax base subject to GILTI.²⁰³

country can produce excess credits.

199. See Sullivan, *supra* note 195, at 845.

200. See Shaviro *Part 2*, *supra* note 188, at 184.

201. See *id.* (discussing the tension between these two viewpoints).

202. The new expensing provision does not apply for purposes of determining asset basis under GILTI or FDII (discussed *infra* Part IV.B) regimes. I.R.C. §§ 250(b)(2)(B), 951A(d)(3) (2017). Instead, the slower depreciation schedule of section 168(g) is used. See *id.* §§ 168(g), 951A(d)(3).

203. The tax bill also changes the rules governing where income is sourced when it comes from inventory that is partly produced in the United States and partly produced abroad. *Id.* § 863(b)(2). Prior law allowed taxpayers to effectively allocate half of the income to foreign sources by designating title to pass abroad. I.R.C. § 863(b) (1997) (amended 2017). The new provision simply looks at location of production, which, like the minimum tax formula, may further incentivize firms to locate real production activities abroad. I.R.C. § 863(b) (2017) (apportioning “solely on the basis of the production activities”).

Consider a firm that invests \$10,000,000 in a plant abroad that will generate \$1,000,000 of income. The firm will get to exempt all of that \$1,000,000 of income through the deemed 10% return so that there is no U.S. tax. By contrast, a firm investing in a \$10,000,000 plant in the United States that will generate \$1,000,000 of income pays U.S. tax of \$210,000 (21% of \$1,000,000).²⁰⁴

Where there happens to be non-exempt return to tangible assets (return in excess of 10%), this is taxed by the GILTI regime at 10.5% instead of the 21% rate applicable to domestic income. The minimum tax in this case might also be zero if the taxpayer pays enough overall foreign taxes. To build on the above example, assume that the \$10,000,000 plant now generates \$2,000,000 (instead of \$1,000,000). The firm will still get to exempt \$1,000,000 of the income through the deemed 10% return, but the other \$1,000,000 will be subject to the GILTI regime and taxed at an effective rate of 10.5%. This would produce U.S. tax of \$105,000 (10.5% of \$1,000,000), as compared to U.S. tax of \$420,000 (21% of \$2,000,000) on a similar U.S. based investment.

This analysis, thus far, excludes foreign taxes. Higher local taxes abroad can sway the calculus of where to invest back to favoring the United States. We might then expect the GILTI regime to encourage offshoring only where low-taxed countries are a viable alternative location. The ability to cross-credit income through the global feature of the minimum tax, however, complicates this analysis, making offshoring more likely.²⁰⁵

Of course, non-tax considerations, such as the quality of the labor force, will also affect the decision of whether to invest in the United States versus abroad. Such considerations may weigh against locating in a tax haven.²⁰⁶ Even with these additional layers of analysis, we can expect the GILTI regime, at the margins, to induce taxpayers to increase their tangible assets abroad, carrying jobs along with them. These dynamics run contrary to Congress's pronounced policy objective of discouraging offshoring.

204. I.R.C. § 11. Note that the rate on the income from the U.S. plant would be lower if such income was export income, which is effectively taxed at a 13.125% rate in the new tax legislation. *Id.* § 250(a). Note also that the firm will get to expense investments of tangible property, but not real estate. *Id.* § 168(k).

205. *See supra* Part IV.A.1.

206. *See supra* note 198 and accompanying text.

3. Reform Possibilities

The offshoring incentives created by GILTI are fundamental to the structure of the new legislation and cannot be cured by regulation.²⁰⁷ Going forward, Congress could restore balance to the GILTI regime through relatively easy, at least from a design perspective, legislative fixes.²⁰⁸

The former U.S. international tax system has been described as a worldwide system of taxation since it subjected foreign earnings to U.S. taxation (whereas a territorial system of taxation exempts such earnings).²⁰⁹ That being said, the former system never fully taxed such earnings since taxation could be deferred, even indefinitely, on active income earned by foreign subsidiaries.²¹⁰ It thus could be more properly described as a quasi-worldwide system.²¹¹

In contrast, the new regime has been labeled a territorial system since 10% corporate shareholders can exempt the foreign income of foreign subsidiaries altogether through the new participation exemption system.²¹² Here again, however, we see the meaninglessness of such labels since smaller corporate share-

207. The conference report suggests that certain non-economic transactions be disregarded in this context, however this language will not discourage firms from locating real assets offshore in order to reduce the minimum tax since such transactions will produce real economic consequences. H.R. REP. NO. 115-466, at 645 (2017). The report goes further to state that:

the conferees expect the Secretary to prescribe regulations to address transactions that occur after the measurement date of post-1986 earnings and profits under [the provision on one-time repatriation], but before the first taxable year for which [the GILTI provision] applies [2018], if such transactions are undertaken to increase [qualified business asset investment].

Id. This language is aimed at transitional planning tactics like those identified by Stephen Shay rather than the asset shifting problem we identify. Stephen Shay, Tax Reform – Process Failures, Loopholes and Wealth Windfalls 2–4 (Nov. 21, 2017) (unpublished manuscript), <http://ssrn.com/abstract=3076151>.

208. For reform options regarding the new international tax provisions generally, including those suggested in prior versions of this Article, see JANE G. GRAVELLE & DONALD J. MARPLES, CONG. RESEARCH SERV., R45186, ISSUES IN INTERNATIONAL CORPORATE TAXATION: THE 2017 REVISION (P.L. 115-97) 32–41 (2018), <https://fas.org/sgp/crs/misc/R45186.pdf>.

209. *See id.* at 1.

210. *Id.* at 2.

211. *Id.*; see MARK P. KEIGHTLEY & JEFFREY M. STUPAK, CONG. RESEARCH SERV., R44013, CORPORATE TAX BASE EROSION AND PROFIT SHIFTING (BEPS): AN EXAMINATION OF THE DATA 17 (2015) (discussing the futility of the worldwide and territorial labels); Shaviro *Part 1, supra* note 188, at 58 (same).

212. I.R.C. § 245A (2017).

holders and individuals are still subject to taxation on their foreign income.²¹³ Furthermore, the GILTI regime means that even foreign income of 10% corporate shareholders is likely subject to *some* U.S. taxation. These worldwide-type features were retained since a move to a pure territorial system would worsen profit shifting incentives by exempting foreign-source income altogether (rather than just allowing it to be deferred without current U.S. taxation).²¹⁴

It has been pointed out that the GILTI regime could be viewed as either a transition to a more pure worldwide system of taxation, achieved after raising the rate of minimum tax, or, as a stepping stone to a more pure territorial system, achieved after lowering the rate.²¹⁵ Experts worried about profit shifting will likely advocate for the former, and those concerned about competitiveness and inversions by U.S. companies will likely press for the latter.²¹⁶ It is impossible to predict in which direction the U.S. system will evolve, but it is almost certain that the system will continue on in hybrid form, somewhere between territorial and worldwide.²¹⁷

Generally speaking, we think the existence of a partial territorial system coupled with a minimum tax as a backstop is an improvement over the prior worldwide system with deferral of active foreign income.²¹⁸ From a revenue and base protection standpoint, it is also preferable to a system that would completely exempt such earnings. Nonetheless, although a minimum tax can work in theory, its current GILTI incarnation presents the problematic offshoring and profit shifting incentives discussed above.

The problem of cross-crediting could be addressed by moving to a per-country minimum tax rather than one done on a global

213. *Id.* § 951.

214. Fleming et al., *supra* note 197, at 76.

215. *Id.*

216. For a skeptical account of whether inversions can be explained by an anti-competitive U.S. tax environment, see Edward D. Kleinbard, 'Competitiveness' Has Nothing to Do With It, 144 TAX NOTES 1055 (2014).

217. See KEIGHTLEY & STUPAK, *supra* note 211; Shaviro *Part 1*, *supra* note 188, at 58.

218. See generally J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Worse Than Exemption*, 59 EMORY L.J. 79 (2009) (criticizing the deferral system).

basis.²¹⁹ Although administratively more complex, many commentators have endorsed such an approach given its favorable effect on base erosion and revenue concerns.²²⁰ Moving to a per-country approach would also reduce the offshoring incentives in the bill, at least for those countries with corporate tax rates at or above that of the United States.

One way to target the offshoring incentives created by the GILTI regime could be to change the tax base of the regime. Instead of allowing an exemption for a return on foreign tangible assets, for instance, the minimum tax could apply to all foreign source (non-Subpart F) income.²²¹ Another way to close the gap between foreign income and domestic income would be to keep the 10% hurdle rate but subject the excess to the normal corporate rate of 21% (rather than the 10.5% rate).²²²

Still another option would be to set the deemed return on foreign tangible asset basis at a lower rate than 10%. Congress presumably chose the 10% hurdle rate so that the GILTI regime would capture income only from intangibles, since these generate higher rates of return. The rate Congress chose, however, is arbitrary.²²³ The deemed return on tangible assets is set rela-

219. This approach has been pursued in recently proposed legislation. Per-Country Minimum Act, H.R. 6015, 115th Cong. (2018).

220. KEIGHTLY & STUPAK, *supra* note 211, at 17–18; Fleming et al., *supra* note 197, at 77.

221. President Obama's budget included a proposed 19% minimum tax on the foreign earnings of controlled foreign corporations or foreign branches or from the performance of services abroad. See DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2016 REVENUE PROPOSALS 19–22 (2015), <https://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2016.pdf>. Like the GILTI regime, the minimum tax proposal would have exempted a return on foreign assets. *Id.* at 21. Another minimum tax proposal would exempt active foreign business income. This proposal is similar to one introduced by Senator Enzi. S. 2091, 112th Cong. (2012). For other minimum tax proposals, see STAFF OF JOINT COMM. ON TAXATION, 113TH CONG., TECHNICAL EXPLANATION OF THE TAX REFORM ACT OF 2014 (2014); Press Release, U.S. Senate Comm. on Fin., Baucus Unveils Proposal for International Tax Reform (Nov. 19, 2013), <https://www.finance.senate.gov/chairmans-news/baucus-unveils-proposals-for-international-tax-reform>.

222. Reuven S. Avi-Yonah, *How Terrible Is the New Tax Law? Reflections on TRA175* n.4 (Univ. of Mich. Law Sch. Pub. Law & Legal Theory Research Paper Series Draft Paper No. 586, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3095830; see also Fleming et al., *supra* note 197, at 78 (giving examples of the interaction between corporate and foreign tax rates).

223. The normal rate of return is the lowest rate of return that will attract investment. Normal rates of return are exceeded due to intangibles, monopoly power, monopsony power, exchange rate variations, among other variables. See

tively high at 10% as compared to the risk-free return on Treasury yields.²²⁴ This allows a great deal of a company's return on investments in real assets abroad to be completely exempt from U.S. taxation. Instead, the deemed normal return could be the short-term risk-free rate or such rate as adjusted by a variable, contemporaneous measure of market performance.²²⁵

These solutions could all be critiqued as moving too far in the direction of worldwide taxation. If this is a concern, the minimum tax could be imposed at a lower rate. Caution should be taken in lowering the rate, however, since this would impact revenues and would also lead to increased profit shifting and base erosion by widening the disparity between the domestic rate and the foreign minimum rate.

B. PROBLEMS WITH THE FDII REGIME

Whereas the GILTI regime was intended as the stick for earning income from intangibles abroad, the foreign-derived intangible income (FDII) regime was intended to be the carrot for earning such income within the United States.²²⁶ To this end, FDII provides an effective rate of tax of 13.125%²²⁷ on so called foreign-derived intangible income to keep intellectual property within the United States. In theory, a domestic corporation's FDII is its portion of intangible income derived from foreign markets. However, as is the case with the GILTI regime, the intangible aspect comes only from defining the FDII base as the excess over the deemed return on tangible investment rather than as intangible income per se. This distinguishes FDII from other pa-

MARTIN A. SULLIVAN, TAX NOTES, ECONOMIC ANALYSIS: WHERE WILL THE FACTORIES GO? A PRELIMINARY ASSESSMENT 4 (2018), <https://www.taxnotes.com/tax-reform/economic-analysis-where-will-factories-go-preliminary-assessment>. Moreover, there is no requirement that intangibles be present in order to trigger the GILTI regime. *Id.* at 2.

224. I.R.C. §§ 1291(c)(3), 6621 (2017).

225. See Shaviro *Part 2, supra* note 188, at 182 (suggesting a market rate of interest).

226. A perhaps more accurate description is that GILTI is itself a carrot. After all, 10.5% is better than 21%. Under this view, FDII is simply a tastier carrot. Chris William Sanchirico, *The New U.S. Tax Preference for "Foreign-derived Intangible Income"*, 71 TAX L. REV. (forthcoming 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3171091.

227. This lower rate is effectively achieved through a 37.5% deduction. At the 21% corporate rate, this amounts to a 13.125% rate on FDII. I.R.C. § 250(a)(1). For tax years beginning after 2025, the 37.5% deduction is reduced to 21.875%, and thus the effective rate on FDII goes up to 16.406% in those years. *Id.* § 250(a)(3).

tent box regimes, which grant tax incentives to patents and copyright software, because it instead includes branding and other market-based intangibles.²²⁸

1. WTO Violations

Problematically, the FDII regime is likely an illegal export subsidy in violation of WTO agreements.²²⁹ Accordingly, it has the danger of reviving a three-decades long controversy between the United States and the European Union that was thought to have been put to rest in 2004.²³⁰ This is because the greater the U.S. taxpayer's income from exports, the more of its income gets taxed at the FDII 13.125% rate (as opposed to the full 21% corporate rate).

Specifically, FDII is defined as the amount that bears the same ratio to the corporation's "deemed intangible income" as its "foreign-derived deduction eligible income" bears to its "deduction eligible income."²³¹ "Deemed intangible income" is the excess of a domestic corporation's "deduction eligible income" (essentially modified gross income, determined without regard to subpart F income, GILTI, and a few other enumerated categories) over its "deemed tangible income return" (10% of its basis in its tangible assets).²³²

In turn, "foreign-derived deduction eligible income" is defined as income derived in connection with (1) property that is sold by the taxpayer to any foreign person for a foreign use or (2) services to any foreign person or with respect to foreign property.

228. Altmaier et al., *EU Finance Ministers Warn Against Proposed U.S. Tax Measures*, TAX NOTES (Dec. 11, 2017), <https://www.taxnotes.com/beps-expert/base-erosion-and-profit-shifting-beps/eu-finance-ministers-warn-against-proposed-us-tax-measures/2017/12/11/1xdr8>.

229. The General Agreement on Tariffs and Trade (GATT) and its later WTO-enforced incarnations limit export subsidies (in addition to tariffs on imports). Export subsidies can include income tax incentives, and these agreements have indeed been used against several U.S. tax regimes. See, e.g., Paul R. McDaniel, *The David R. Tillinghast Lecture Trade Agreements and Income Taxation: Interactions, Conflicts, and Resolutions*, 57 TAX L. REV. 275, 280–83 (2004).

230. For prior discussion by one of us, see Rebecca Kysar, *The Senate Tax Plan Has a WTO Problem*, MEDIUM: WHATEVER SOURCE DERIVED (Nov. 12, 2017), <https://medium.com/whatever-source-derived/the-senate-tax-plan-has-a-wto-problem-guest-post-by-rebecca-kysar-31deee86eb99>.

231. I.R.C. § 250(b).

232. *Id.*

In other words, this category comprises exports for property and services.²³³

In summary, a U.S. company's foreign derived intangible income is the amount that bears the same ratio to the deemed intangible income as the U.S. company's exports bear to its modified gross income. Another way of looking at this is that a percentage of income from exports is taxed at the 13.125% rate, the percentage being the ratio of the deemed intangible income of the U.S. company to the modified gross income of the U.S. company. The greater the income from exports, the greater the amount of income that gets the 13.125% rate, which is a subsidy in comparison with the baseline 21% rate that would apply to imports.

Because the FDII regime benefits exports, it violates WTO obligations—specifically, Article 3 of the Agreement on Subsidies and Countervailing Measures (SCM). The SCM prohibits (a) subsidies that are contingent, in law or fact, upon export performance and (b) subsidies that are contingent upon the use of domestic over imported goods.²³⁴ Article 1 of the SCM defines a subsidy as a financial contribution by a government, including the non-collection or forgiveness of taxes otherwise due.²³⁵ If a country enacts export subsidies, other countries can impose countervailing measures against it.²³⁶

The language regarding “taxes otherwise due” raises baseline questions. It has been suggested that the proper baseline should be a territorial system, allowing for participation exemption.²³⁷ Since a taxpayer could just incorporate abroad and take advantage of that system, then judged against that baseline, the 13.125% rate cannot be seen as forgiveness or non-collection of taxes otherwise due. WTO rulings, however, tend to be formalistic²³⁸ and do not generally anticipate taxpayer responses. For instance, in judging prior export subsidies, the WTO implicitly ignored the fact that a firm could park its income offshore and

233. *Id.*

234. Agreement on Subsidies and Countervailing Measures art. 3.1, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1A, 1869 U.N.T.S. 14 [hereinafter SCM].

235. *Id.* at art. 1.1(a)(1)(ii).

236. *See, e.g., id.* at art. 7.9.

237. *See* Sanchirico, *supra* note 226, at 9–12.

238. *See* Steve Lohr, *New Approach to Corporate Tax Law has House G.O.P. Support*, N.Y. TIMES (Dec. 12, 2016) (quoting Michael Graetz as characterizing WTO lawyers as embracing formalism).

grind its tax rate down to zero through deferral.²³⁹ Instead, prior export subsidies were judged against a system of worldwide taxation without deferral.

Furthermore, it is unclear why the comparison should be the taxation of foreign subsidiaries given that the FDII regime also benefits domestic corporations without foreign operations at all. For such corporations to receive the FDII deduction, they need only export goods. It thus seems odd to call upon them to incorporate abroad in an imagined exercise if they have no activity abroad. Instead, the proper baseline should be the applicable tax rate imposed on the domestic corporation as if it had sold its goods here, rather than exported them—21%.

The United States may also argue that intangible income lies outside the scope of the WTO agreements,²⁴⁰ but the intangible income in the legislation is simply a deemed portion of the income from the sale of tangible goods.²⁴¹ Exports of tangible goods are clearly covered by the agreements,²⁴² and thus the FDII rate will almost certainly fall within their scope. Because FDII amounts to the non-collection or forgiveness of taxes otherwise due on an export, it likely will be considered a prohibited export subsidy under SCM. Accordingly, our trading partners will likely impose sanctions, either unilaterally or after approval from the WTO's Dispute Resolution Body.²⁴³

It is important to note that the history of this controversy is long and tortured, beginning in 1971 with tax provisions that were enacted by the Nixon Administration and designed to help exports (the Domestic International Sales Corporation or DISC provisions).²⁴⁴ Almost immediately, the European Community

239. See generally DAVID L. BRUMBAUGH, CONG. RES. SERVICES, A HISTORY OF THE EXTRATERRITORIAL INCOME (EIT) AND FOREIGN SALES CORPORATION (FSC) EXPORT TAX-BENEFIT CONTROVERSY 1, 6, 8, 11–12, 14, 18 (2006).

240. This argument was briefly raised by GOP Senators in markup.

241. I.R.C. § 250(b) (2017).

242. See, e.g., General Agreement on Tariffs and Trade, Oct. 30, 1947, 61 Stat. A-11, 55 U.N.T.S. 194 (creating trade rules for imports and exports of goods).

243. Reuven S. Avi-Yonah, *The Elephant Always Forgets: Tax Reform and the WTO* 5 (Univ. of Mich. Law Sch. Law & Econ. Research Paper Series, Paper No. 18-001, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3095349.

244. Revenue Act of 1971, Pub. L. No. 92-178, § 501–07, 85 Stat. 535–53 (1971). For a history of the export tax subsidy controversy, see DAVID L. BRUMBAUGH, CONG. RESEARCH SERV., RL31660, A HISTORY OF THE EXTRATERRITORIAL INCOME (ETI) AND FOREIGN SALES CORPORATION (FSC) EXPORT TAX-BENEFIT CONTROVERSY (2006).

contested the DISC provisions under GATT, the WTO's predecessor.²⁴⁵ In 1976, a GATT panel ruled against DISC,²⁴⁶ and the United States eventually replaced the system with the FSC provisions in 1984.²⁴⁷

The WTO would later rule against the FSC system.²⁴⁸ In 2000, Congress enacted the ETI system to replace the illegal Foreign Sales Corporation system.²⁴⁹ Yet, in 2002 the WTO decided that the tax benefits provided under ETI were illegal export subsidies.²⁵⁰ Congress eventually gave up the fight. The repeal of ETI was the impetus for the American Jobs Creation Act of 2004 (and the now repealed section 199 deduction for domestic manufacturing).²⁵¹

As a result of the new tax legislation, we can thus expect this protracted battle to be reignited. Taxpayers should expect instability in this area, and the United States should prepare for WTO litigation. Indeed, just before the bill was passed, the foreign finance ministers of Britain, France, Germany, Italy, and Spain sent a letter to Treasury Secretary Mnuchin warning him of the possible WTO violations in this regime.²⁵²

If history is any guide, the United States will abandon the export subsidy regime under threat of sanctions. Another possible outcome, however, is that Congress and the Trump administration continue down the path of economic nationalism and simply pay sanctions instead of changing the law in response to a negative WTO ruling.²⁵³

245. Report of the Panel, United States Tax Legislation (DISC), L/4422, Nov. 12, 1976, GATT B.I.S.D. (23rd Supp.) (1981).

246. STAFF OF THE JOINT COMM. ON TAXATION, 98TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, at 1041-43 (Joint Comm. Print 1984).

247. *Id.* at 67-76.

248. Panel Report, *United States—Tax Treatment for “Foreign Sales Corporations”*, 207, WTO Doc. WT/DS108/R (Oct. 8, 1999).

249. FSC Repeal and Extraterritorial Income Exclusion Act of 2000, Pub. L. No. 106-519, 114 Stat. 2423.

250. Panel Report, *United States—Tax Treatment for “Foreign Sales Corporations”—Recourse to Article 21.5 of the DSU by the European Communities*, 60, WTO Doc. WT/DS108/RW (Aug. 20, 2001).

251. American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418 (2004).

252. Altmaier et al., *supra* note 228. The finance ministers note that the export regime is different from accepted patent box regimes in that it applies to intangible assets other than patents and copyright software, such as branding and other market-based intangibles.

253. Avi-Yonah, *supra* note 243, at 6-7.

To quote one senior GOP lobbyist: “[A]ny WTO challenge could threaten the existence or efficacy of the WTO because of this context. Or threaten the US willingness to continue as a member. As between tax cuts and the WTO, the GOP free traders would likely choose tax cuts.”²⁵⁴ In this scenario, the tax measures pursued in this bill may further destabilize the free-trade order. Indeed, with the failure to reach new agreements at the WTO conference as U.S. tax reform was pending, there is already some indication that this is occurring.²⁵⁵

To summarize, the special low rate of 13.125% in the Senate bill for export income is intended to encourage firms to keep and develop intangible property in the United States. Given its uncertain legal status, however, firms will not be able to rely upon the change and will continue to locate IP offshore. It is thus unlikely that the FDII regime will fulfill its intended purpose.

2. Gaming Involving Round-Tripping Transactions

Other technical problems will also arise from the new FDII regime, including new gaming opportunities. Under plausible interpretations of the statute, taxpayers may be able to take advantage of the lower FDII rate in “round-tripping” transactions—that is, selling to independent foreign distributors, who then resell back into the United States. Here, the concern is that domestic sales, which do not get the preferred FDII rate, will be successfully disguised as tax-preferred export sales.

For instance, domestic corporations could sell to technically independent foreign distributors who resell into the United States, but with the domestic corporations imposing advertising and marketing requirements and price restrictions upon those distributors. This approach would give the domestic corporation substantial control without violating the technical independence of the distributors. Although the new tax legislation provides that taxpayers must establish to the satisfaction of the Treasury Secretary that the goods are sold for use abroad,²⁵⁶ taxpayers will likely take the position that the intent of an initial sale to a

254. *Id.* at 7 (quoting an anonymous senior GOP lobbyist).

255. Michael Nienaber, *World Trade Order in a Wobble as Washington Snubs WTO Status Quo*, REUTERS (Dec. 15, 2017), <https://www.reuters.com/article/us-global-economy-outlook/world-trade-order-in-a-wobble-as-washington-snubs-wto-status-quo-idUSKBN1E91GY>.

256. H.R. REP. NO. 115-466, at 625 (2017) (Conf. Rep.).

foreign business is sufficient.²⁵⁷ It will be difficult for the IRS to meaningfully police these sorts of gaming transactions.

Further exacerbating the round-tripping problem, the conference report to the new tax legislation states that, “[i]f property is sold by a taxpayer to a person who is not a U.S. person, and after such sale the property is subject to manufacture, assembly, or other processing . . . outside the United States by such person, then the property is for a foreign use.”²⁵⁸ This presumably allows for round-tripping so long as there is some degree of foreign processing, since otherwise this rule would not be necessary. It is possible that, by negative implication, the conferees aimed to imply that a sale for re-importation purposes would not be considered to be for foreign use in the absence of further foreign processing. But even if this interpretation of the negative implication is correct, there will be enormous pressure on the minimum amount of foreign processing necessary to qualify as foreign use, allowing re-importation into the United States.²⁵⁹

Ultimately, then, whatever the interpretation, it is hard to see how the IRS could prevent numerous taxpayers from engaging in round-tripping games to exploit the FDII regime. The legal and factual ambiguity inherent to any such enforcement attempts will undoubtedly advantage taxpayers who seek to engage in aggressive tax gaming, similar to the case with transfer-pricing games.

3. Other Perverse Incentives

FDII also creates undesirable incentives to locate economic activity abroad, much like GILTI. Firms can obtain the lower FDII rate while having zero manufacturing or employees in the United States—buying goods from a foreign supplier for resale abroad is sufficient. Moreover, because the FDII rate applies to income in excess of a domestic corporation’s tangible assets,²⁶⁰ domestic corporations can lower the hurdle necessary to obtain the favored rate by reducing tangible investments in the United States.

257. This would be akin to how a VAT regime would work, although Treasury would likely contest this analogy as inappropriate given the differences between that type of regime and the FDII regime.

258. H.R. REP. NO. 115-466, at 625 n.1522.

259. Regulations to address this point will be necessary, although it is questionable how effective they can be given the fact-intensive nature of the inquiry. Thanks to Mike Schler for discussion of this point.

260. See I.R.C. § 250 (2017).

Perversely, the FDII rate also incentivizes firms to sell to foreign manufacturers rather than to domestic manufacturers. This is because a U.S. firm will be unable to obtain the FDII rate when it sells unfinished goods to an unrelated U.S. manufacturer (since this qualifies as a domestic sale), but will be able to obtain the FDII rate when it sells unfinished goods to a related or unrelated foreign manufacturer (since this qualifies as an export).

Finally, although FDII is intended to attract IP to the United States, its rate of 13.125% simply cannot compete with GILTI's rate of 10.5%, assuming the proper comparison is a tax haven. Even if a foreign country imposes tax at a rate of 13.125%, which equalizes the FDII rate if the foreign taxes are 80% creditable, this only means that in such scenarios FDII is taxed equal to GILTI.

4. Reform Possibilities

In light of these troubling incentives for offshoring, the potential for aggressive tax gaming, the legal uncertainty from drafting glitches, and the roadblocks arising from the likely incompatibility with WTO rules, we believe that the best course of action is for Congress to repeal FDII entirely. This is especially the case considering the mixed evidence as to whether even better designed patent boxes increase R&D or employment.²⁶¹ Problematically, FDII incentivizes marketing intangibles, goodwill, and going concern, rather than just R&D. Although there is a strong argument for incentivizing R&D because it generates positive spillover effects, the same cannot be true for these other kinds of IP.²⁶²

If Congress nevertheless wishes to maintain FDII, at minimum new legislation should establish improved anti-round-trip-

261. Michael J. Graetz & Rachael Doud, *Technological Innovation, International Competition, and the Challenges of International Income Taxation*, 113 COLUM. L. REV. 347, 375 (2013) (reviewing the literature to conclude that the effectiveness of patent boxes is mixed, only affecting the location of IP ownership and income rather than R&D in some countries); see also Annette Alstadsaeter et al., *Patent Boxes Design, Patents Location, and Local R&D*, 33 ECON. POLY 131 (2018) (finding that patent boxes tend to deter local innovation activities unless such regimes impose local R&D conditions); Pierre Mohnen et al., *Evaluating the Innovation Box Tax Policy Instrument in the Netherlands, 2007–13*, 33 OXFORD REV. ECON. POLY 141, 141 (2017) (finding that the patent box in the Netherlands has a positive effect on R&D but that the average firm only uses a portion of the tax advantage for extra R&D investment).

262. See Sanchirico, *supra* note 226, at 20.

ping rules to prevent the easy gaming of the export subsidy. Absent such legislation, Treasury should attempt to address such transactions through regulation. For instance, Treasury might use rules similar to those that determine destination under the base company rules to determine whether a sale is for foreign use.²⁶³ Problems with those rules, however, illustrate the difficulties in addressing the round-tripping issue, especially through regulation rather than legislation.

In particular, the base company regulations mandate that corporations determine the country of ultimate use “if at the time of a sale of personal property to an unrelated person the controlled foreign corporation knew, or should have known from the facts and circumstances surrounding the transaction, that the property probably would not be used, consumed, or disposed of in the country of destination”²⁶⁴ This leaves substantial wiggle room for there to be no duty for U.S. firms to determine which property will be resold into the United States when they sell property to an independent foreign party for resale. Thus, in light of the statutory requirement that taxpayers show to the satisfaction of Treasury that the property is exported for foreign use, Treasury should use its regulatory authority to impose an interpretation of the statute that requires U.S. manufacturers to do a real investigation of how much the foreign party will sell back into the United States. Yet, given the fact-intensive nature of the inquiry, it is admittedly unclear how effective any such regulations would be.

Further, if the FDII is retained, we recommend closing the gap between the rates on FDII and GILTI to avoid taxing the export income more heavily than the foreign intangible income (an undesirable result given the aims of the reform). The conference report states the lower minimum tax rate under GILTI is justified because only 80% of the foreign tax credits are allowed to offset the minimum tax rate.²⁶⁵ This justification, however, does not hold if no or low foreign taxes are paid (for example, in tax havens), which are precisely the circumstances at which the GILTI regime is aimed. In such cases, firms will pay a 10.5% rate in the U.S. (or close to it). Given the goal of using the export rate to encourage firms to bring intellectual property back home, this policy choice is questionable. A rate somewhere in between

263. See Treas. Reg. § 1.954-3(a)(3)(ii) (2018).

264. *Id.*

265. See H.R. REP. NO. 115-466, at 649 (2017) (Conf. Rep.). The effective GILTI rate of 10.5% divided by 80% equals 13.125%.

10.5% and 13.125% could have been chosen to account for the tax haven problem.

C. PROBLEMS WITH THE BEAT REGIME

One of the more interesting provisions in the new tax legislation is the new base erosion and anti-abuse tax (BEAT), which significantly strengthens U.S. taxation of inbound transactions.²⁶⁶

The BEAT targets base erosion of the U.S. tax base by imposing additional tax liability on certain U.S. corporations that excessively reduce their U.S. tax liability by making deductible payments to a 25% owned foreign affiliate.²⁶⁷ The BEAT applies to all multinational corporations, whether they are owned by a U.S. or by a foreign parent corporation.²⁶⁸

The BEAT is a minimum tax that is calculated on an expanded tax base called “modified taxable income,” which is determined without regard to tax benefits, such as deductions, arising from “base erosion payments.”²⁶⁹ Base erosion payments, in turn, are defined as deductible amounts paid to the foreign affiliate,²⁷⁰ such as interest, amounts paid to the foreign affiliate in connection with depreciable or amortizable property,²⁷¹ and certain reinsurance premiums.²⁷² The minimum tax is equal to the excess of 10% of the modified taxable income over an amount equal to the taxpayer’s regular tax liability (reduced by certain credits).²⁷³

The BEAT was conceived of as a punishment to companies that invert (that is, U.S. companies that change their domicile to a foreign country). Inversions were attractive under prior law, in part, because the U.S. entity could be loaded up with debt, thereby generating deductible interest payments to the new foreign parent and stripping income out of the U.S. tax base.²⁷⁴ BEAT’s scope, however, is much wider than just this, applying to payments to foreign subsidiaries as well as foreign parents.

266. I.R.C. § 59A (2017).

267. *Id.*

268. *Id.*

269. *Id.* § 59A(c).

270. *Id.* § 59A(d)(1).

271. *Id.* § 59A(d)(2).

272. *Id.* § 59A(d)(3).

273. *Id.* § 59A(b)(1).

274. Avi-Yonah, *supra* note 243, at 3.

1. The Cost of Goods Sold Game

Importantly, base erosion payments generally do not include payments for cost of goods sold.²⁷⁵ If a foreign affiliate incorporates the foreign intellectual property into a product and then sells the product back to a U.S. affiliate, the cost of the goods sold does not fall within BEAT.²⁷⁶ Even if the U.S. subsidiary pays a royalty to the foreign parent for the right to use a trademark on goods purchased by the subsidiary, the royalty must be capitalized into the costs of goods sold under pre-existing regulations, and therefore the royalty payments skip the BEAT entirely.²⁷⁷ This gap in the law leaves open significant gaming opportunities, ensuring that a good deal of base shifting will escape the regime.

2. Matters of Thresholds

Problematically, the scope of BEAT allows many multinationals to fall outside of it. The BEAT regime only applies to corporations that have average annual gross receipts in excess of \$500 million over a three-year period.²⁷⁸ This is a very high threshold, leaving out many corporations that are engaging in substantial base shifting. To compare, in a similar setting focused on base erosion, the section 385 regulations identify large multinationals as having either \$50 million in annual revenues or assets exceeding \$100 million.²⁷⁹ These levels are much more appropriate for identifying multinationals with sufficient base shifting activity.²⁸⁰

The BEAT regime is not triggered until there is a “base erosion percentage” of at least three percent, or two percent for financial groups.²⁸¹ This creates a cliff effect, incentivizing companies to engage in structures to get just inside the line. For

275. H.R. REP. NO. 115-466, at 653 (2017) (Conf. Rep.).

276. *See id.*

277. Treas. Reg. § 1.263A-1(e)(3)(ii)(U) (2018). There is a question as to whether Congress intended such royalties to escape BEAT. One government official has indicated that this was not the intent of Congress and that the outcome may be changed through a technical correction. JASPER L. CUMMINGS, TAX NOTES, SELECTIVE ANALYSIS: THE BEAT 1763 (2018).

278. I.R.C. § 59A(e)(1)(B) (2017).

279. *Id.* § 385.

280. Bret Wells, *Get with the Beat*, 158 TAX NOTES 1023, 1023 (2018).

281. I.R.C. § 59A(e). The base erosion percentage is determined by dividing the deductions taken by the taxpayer with respect to its base erosion payments by the overall amount of deductions taken by the corporation (with some enumerated exceptions, such as for deductions in connection with GILTI and FDII).

instance, the domestic corporation could “check the box” on its foreign subsidiary to treat it as a “disregarded entity” for federal income tax purposes. In this manner, the subsidiary, and payments to it, would be ignored.

Finally, because the BEAT is only assessed at a 10% rate, it allows deductions to offset over half the 21% percent corporate tax rate, a result that arguably does not punish base shifting sufficiently.²⁸²

3. International Law Issues

The BEAT also raises tax treaty issues, although the United States will almost certainly take the position that these concerns should be dismissed.²⁸³ A group of EU Ministers, in raising the previously discussed WTO issues in the FDII regime, asserted that the BEAT regime could discriminate against foreign companies in violation of bilateral tax treaties and could constitute unfair trade practices because it also encompasses non-abusive transactions.²⁸⁴

Article 24(5) of our double tax treaties provides that a treaty partner cannot tax residents of the other treaty country more heavily than its own residents.²⁸⁵ Arguably, the BEAT violates

Id. § 59A(c)(4).

282. Avi-Yonah, *supra* note 4, at n.4.

283. There is also a question as to the consequences that flow from the BEAT conflicting with the tax treaties. One understanding is that if the BEAT contradicts the treaties, courts must abide by the “later in time” rule to nonetheless apply the BEAT as written, omitting foreign tax credits and applying it to non-deductible payments to residents in the treaty country. This is because under the U.S. Constitution, treaties and statutes are both “supreme law” and the Court has held that, when there is a conflict between the two, the one enacted “later in time” will prevail. *Whitney v. Robertson*, 124 U.S. 190, 194 (1888). A contrary view argues that courts should not find that a statute has overridden a treaty unless Congress has clearly expressed its will to do so. Under this view, courts must reinterpret the BEAT to allow for deductions to related persons resident in treaty countries and foreign tax credits for foreign taxes paid to treaty countries. See H. David Rosenbloom & Fadi Shaheen, *The BEAT and the Treaties*, 92 TAX NOTES INT’L 1 (2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3229532. Some of us have argued the former and disagreed with the latter view. Reuven Avi-Yonah & Bret Wells, *The BEAT and Treaty Overrides: A Brief Response to Rosenbloom and Shaheen* (Univ. of Mich. Pub. Law Research Paper No. 617, Aug. 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3232974; Rebecca M. Kysar, *Will Tax Treaties and WTO Rules ‘Beat’ the Beat?*, COLUM. J. TAX L. MATTERS (forthcoming 2018); Rebecca M. Kysar, *Unraveling the Tax Treaty* (draft on file with authors).

284. Stephanie Soong Johnston, *EU Finance Ministers Fire Warning Shot On U.S. Tax Reform*, 157 TAX NOTES 1704, 1704 (2017).

285. The model tax treaty provides:

this nondiscrimination clause because a foreign-owned U.S. entity will be subject to the BEAT regime whereas a U.S.-owned U.S. entity will not be. One rejoinder to this argument is that the BEAT applies regardless of who *ultimately* owns the corporation.²⁸⁶ Thus, the BEAT applies to payments from a U.S. entity to a foreign entity that is owned by the U.S. entity (a CFC), which indicates that “the intent was to protect the U.S. tax base rather than to discriminate against foreign-owned U.S. parties.”²⁸⁷

Another arguable path to treaty violation is Article 24(4), which commands that foreign residents be entitled to deductions “under the same conditions” as U.S. residents.²⁸⁸ The BEAT regime, however, is not equivalent to the denial of a deduction and interest, royalties, and other items remain fully deductible. Instead, the BEAT merely subjects the tax benefit conferred by deducting interest, royalties, and other items to the ten percent tax; denying a tax deduction would increase the tax on the item by 21%, not 10%.²⁸⁹ Additionally, the base erosion rules are arguably sanctioned under Article 24(4) because they are necessary to arrive at an appropriate arm’s length result within the meaning of Article 9 of the treaties.²⁹⁰

Article 23 of the treaties also requires treaty partners to grant a foreign tax credit for income tax of the treaty partner “in accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to

Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned Contracting State to any taxation or any requirement connected therewith that is more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned Contracting State are or may be subjected.

TREASURY DEP’T, UNITED STATES MODEL INCOME TAX CONVENTION art. 24(5) (2016) [hereinafter MODEL INCOME TAX CONVENTION].

286. Although a harsher result applies to foreign companies that were formerly U.S. companies, such disparate treatment is likely within the savings clause of the treaties, which allows the United States to tax its residents, and former residents, under its own domestic law. *Id.* at arts. 1(4), 4(1); see also Wells, *supra* note 280.

287. Reuven S. Avi-Yonah, *Beat It: Tax Reform and Tax Treaties* (Univ. of Mich. Pub. Law Research Paper No. 587, Jan. 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3096879.

288. MODEL INCOME TAX CONVENTION, *supra* note 285, at art. 24(4).

289. Avi-Yonah, *supra* note 287.

290. Wells, *supra* note 280, at 1026.

time without changing the general principle hereof).”²⁹¹ Since the BEAT offers no foreign tax credit, it may violate the “general principle” of Article 23.²⁹²

There are, however, cogent arguments against this view. One could characterize the BEAT as simply a limitation on the foreign tax credit because a portion of regular tax liability still receives relief from double taxation in the form of foreign tax credits.²⁹³ Another argument is that the BEAT may not be a “covered tax” under Article 2 of the treaties since it is an alternative regime to the income tax and therefore not subject to the requirements of Article 23.²⁹⁴

The treaty analysis of the BEAT looks even stronger when compared with the original House inbound provision that would have imposed a 20% excise tax to all deductible payments to foreign related parties, including cost of goods sold. In contrast to the BEAT, the excise tax would have also likely abrogated our bilateral tax treaties by effectively imposing a withholding tax on royalties (Article 9) and by undermining the treaties’ arm’s length principle (Article 12), permanent establishment (Article 7), and nondiscrimination (Article 24) requirements.

All of that being said, the nondiscrimination and double tax relief provisions in the tax treaties are vague and contentious. The United States can thus likely expect pressure from our treaty partners to scale back the inbound regime on a bilateral basis. It is unclear, however, how successful any such efforts will be. This is especially so given that Europe’s response to the inbound base erosion problem in the form of ad hoc state aid cases and digital tax proposals could itself be accused of being discriminatory against certain multinational corporations.²⁹⁵ Additionally, many of our treaty partners have enacted new taxes in the

291. MODEL INCOME TAX CONVENTION, *supra* note 285, at art. 23(2).

292. See Rosenbloom & Shaheen, *supra* note 283.

293. Avi-Yonah & Wells, *supra* note 283.

294. *Id.* “Covered taxes” are federal income taxes imposed by the Internal Revenue Code or “any identical or substantially similar taxes that are imposed after the date of signature of this Convention in addition to, or in place of, the existing taxes.” MODEL INCOME TAX CONVENTION, *supra* note 285, at art. 2.

295. See Wells, *supra* note 280, at 1030. For a general discussion of the geopolitical dynamics surrounding BEAT, see Itai Grinberg, The BEAT Is a Pragmatic and Geopolitically Savvy Inbound Base Erosion Rule (Nov. 12, 2017) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3069770.

past several years that are of questionable status with regard to the treaties' scope.²⁹⁶

The BEAT also arguably presents WTO problems and may be viewed as a forbidden tariff, although this argument is much less serious than the WTO problems presented by FDII. Interest and royalties do not create a WTO issue, so only imports of depreciable property from related parties and imports from certain inverted corporations will implicate the agreements.²⁹⁷ The level of WTO-covered import activity subject to increased taxation, however, may be insufficient to raise the ire of our trading partners.²⁹⁸ This is in contrast to the House excise tax proposal. Because it encompassed cost of goods sold, the excise tax would have caused much more significant WTO problems.²⁹⁹

4. Taxpayer Unfriendly Glitches

Although our primary concern is with the under-inclusiveness of the BEAT regime, in some narrow circumstances, the BEAT might also be characterized as being over-inclusive through a number of unfriendly taxpayer quirks. For instance, although there is an exception for qualified derivate payments to accommodate intercompany swaps and other derivatives, ordinary course transactions such as repurchase agreements and posted collateral, as well as certain debt instruments mandated by regulators constitute base erosion payments.³⁰⁰ BEAT also captures routine transactions such as a foreign finance affiliate borrowing for the group and on-lending at cost around the group. As a result, taxpayers may be penalized under BEAT for non-abusive transactions.

296. See Roland Ismer & Christoph Jescheck, *The Substantive Scope of Tax Treaties in a Post-BEPS World: Article 2 OECD MC (Taxes Covered) and the Rise of New Taxes*, 45 *INTERTAX* 382, 386–87 (2017).

297. Reuven Avi-Yonah & Gianluca Mazzoni, *Tit for Tax: How Will Other Countries React to the Tax Cuts and Jobs Act?* (Univ. of Mich. Pub. Law Research Paper No. 581, Dec. 21, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3089052.

298. Under the letter from the European finance ministers to Secretary Mnuchin, mentioned above, however, WTO concerns were not mentioned explicitly in connection to BEAT (although the letter did mention “unfair trade practices” in that context). Johnston, *supra* note 284.

299. Avi-Yonah, *supra* note 243, at 3.

300. *The New 'Not Quite Territorial' International Tax Regime*, DAVIS POLK & WARDWELL LLP, at 13 (Dec. 20, 2017), https://www.davispolk.com/files/2017-12-20_gop_tax_cuts_jobs_act_preview_new_tax_regime.pdf.

Additionally, foreign banks often operate in the United States through branches. The rules do not appear to exempt payments by U.S. groups to foreign related parties who treat such payments as effectively connected income (and hence are subject to U.S. taxation), thus creating a particularly harsh result for taxpayers.

Finally, a firm may not pay the minimum tax on GILTI because they have paid foreign tax. In measuring BEAT, however, the firm has to include GILTI because foreign tax credits are not allowed in the calculation.³⁰¹ This could also be judged as an unjustified incongruence between the regimes.³⁰²

We point out these issues not because, on balance, we think the BEAT is too hostile to taxpayers. Indeed, we think the base shifting opportunities still left open by the regime outweigh the aforementioned taxpayer concerns. Yet, in particular instances, the results created by the BEAT may be disproportionately felt by particular industries, thus destabilizing the regime somewhat.

5. Reform Possibilities

There are several paths that Congress might pursue to improve the BEAT regime. For one, the BEAT should apply to corporations that have less than \$500 million revenue since these firms also engage in base erosion and profit shifting. The revenue threshold should be substantially lowered, and an asset test should be added, mirroring those in the section 385 regulations. Also, the three percent base erosion percentage threshold, which creates a cliff effect in the law, should be eliminated. Further, Congress should consider raising the BEAT rate, which is currently set at a relatively low 10%.

301. Thanks to Ed Kleinbard for this point.

302. There are numerous other technical problems and unanswered questions left open by BEAT, particularly with regard to services, as others have explored. See, e.g., Manal Corwin et al., *A Response to an Off-BEAT Analysis*, 158 TAX NOTES 933 (2018) (arguing that BEAT exempts the cost component of marked-up services); Martin A. Sullivan, *Can Marked-Up Services Skip the BEAT?*, 158 TAX NOTES 705, 705 (2018) (discussing a debate over “which taxpayer payments to foreign related parties are excluded from the definition of base erosion payments potentially subject to the BEAT”); Martin A. Sullivan, *Marked-Up Services and the BEAT, Part II*, 158 TAX NOTES 1169, 1169 (2018) (discussing the applicability of BEAT to certain types of payments); Laura Davison, *Most Wanted: Tax Pros’ Technical Corrections Wish List*, BLOOMBERG (Apr. 13, 2018), <https://www.bna.com/wanted-tax-pros-n57982091110> (discussing ambiguity regarding which payments are included and how to aggregate income).

The BEAT workaround involving cost of goods sold will create planning opportunities going forward and restructuring of the supply chain. Unfortunately, however, there is no easy solution to this problem given the fact that inclusion of cross-border sales of inventory would present WTO problems, similar to those presented by the House excise tax.

D. TAX COMPETITION

Finally, supporters of the new tax legislation sometimes assume that lowering the statutory corporate tax rate to below the OECD average of 25% will result in considerable investment into the United States. Yet other countries will likely respond to the changes enacted by the legislation by engaging in tax competition.³⁰³ For instance, other countries may cut their foreign tax rates further below the new U.S. rate of twenty-one percent.³⁰⁴ They may also adopt patent boxes in response to the lower rate on exported intangibles or may impose greater taxation on U.S. subsidiaries of their own multinationals through rules similar to our controlled foreign corporation rules.³⁰⁵ All of these realistic responses might reduce the growth effects of the legislation and interfere with the intended aims of the new regime. In fact, there is already evidence that other countries have begun to contemplate changes to their own rate structures in response to the new U.S. taxing environment.³⁰⁶

303. A classic example of tax competition is the 1984 U.S. abolishment of a withholding tax on foreign residents who earned portfolio interest. This sparked a “race to the bottom” among governments across the globe, leading to the current state of affairs whereby most countries do not tax interest on debt held by foreign persons. See Reuven S. Avi-Yonah, *A Coordinated Withholding Tax on Deductive Payments*, 119 TAX NOTES 993, 993–94 (2008).

304. This point comes from Dan Shaviro. Note that predictions of an uptick in inbound investment are in tension with the fact that we continue to exist in a low interest rate environment in which corporate CEOs report that capital access presents no constraints on undertaking projects at the margin. However, even if there are no capital allocation effects, the *perception* by other countries will be that the United States has made a strong tax competitive move here. The rates in other countries may well come down in response. This will aggravate the new incentive we have created to move tangible assets out of the United States, as discussed under the GILTI regime. This point comes from Mitchell Kane.

305. For further discussion, see Avi-Yonah & Mazzoni, *supra* note 297, at 1.

306. Laura Davison, *U.S. Tax Overhaul Spurs Others to Re-Evaluate Rates: Tax Counsel*, BLOOMBERG DAILY TAX REP. (Feb. 22, 2018) (quoting one of the key drafters of the tax bill, who has met with representatives from other countries who are looking to model tax law changes after those in the United States).

V. OTHER TECHNICAL PROBLEMS

Although we cannot possibly explain all of the technical problems in the tax legislation within this Article, a few additional issues seem sufficiently important that we feel compelled to discuss at least briefly. We thus explain two additional games and one additional glitch, below.

A. OTHER GAMES

There are many other games that will be played under the new rules created by the tax legislation, undermining revenue collection and the integrity of the tax code—and leading to inefficient behavior. Here we explain two of the most important of these new games.

1. Circumventing the Interest Limitation

One of the most important revenue-raising and anti-abuse provisions of the tax legislation is the new cap on business interest expense deductions, with the cap being set at 30% of an adjusted measure of profits.³⁰⁷ This interest limitation is considered a necessary rule to prevent businesses from deriving a double benefit from the purchase and expensing of debt-financed property.³⁰⁸

However, the tax legislation leaves a door open through which taxpayers can game around this crucial interest limitation.³⁰⁹ This game is easier for pass-through entities than for corporations, and so we will explain the pass-through version of this game first.

The basic game is to pay out preferred returns on equity instead of interest. An attorney who specializes in structuring financial transactions explains the basic version of this game as follows:

Consider a business that currently has interest expense of \$40 on \$100 of [earnings] consisting of \$30 interest expense on senior debt and \$10

307. I.R.C. § 163(j) (2017). Note that the cap excludes interest earned by the business, which may be fully offset by interest paid.

308. ALAN COLE, INTEREST DEDUCTIBILITY—ISSUES AND REFORMS, TAX FOUNDATION FISCAL FACT NO. 548, at 2 (May 2017) (discussing proposed reforms to limit interest deductibility).

309. Our explanation of this game builds on analysis in an earlier blog post by one of us. See Daniel Hemel, *How to Skirt the Cap on Interest Deductions in the GOP Tax Plan . . . and to Make Some Money While You're at It*, MEDIUM: WHATEVER SOURCE DERIVED (Dec. 13, 2017), <https://medium.com/whatever-source-derived/how-to-skirt-the-cap-on-interest-deductions-in-the-gop-tax-plan-bca62fc58a4f>.

of interest expense on subordinated debt. Assume that none of the [prior] law limitations on interest deductibility apply to this business (which would be the typical case). Under the [tax legislation], the business will be limited to a \$30 interest deduction and \$10 will be disallowed.

Commenters have long noted that preferred equity in a partnership provides the equivalent of a tax deductible financing expense (among other alternatives to debt such as leasing arrangements and certain derivatives). Thus, if the business described above were a partnership, it could issue preferred equity to repay the subordinated debt (bringing its interest expense within the \$30 deductibility limit). The preferred equity could be allocated/distributed a fixed annual amount of partnership income (for simplicity, say \$10), economically similar to the previous subordinated debt interest expense. This would divert taxable income away from the common equity partners, with similar effect to preserving interest deductibility for the full \$40 of financing expense.³¹⁰

In other words, a partnership can game around the crucial new interest limitation by substituting some amount of preferred equity for debt. The preferred equity can be structured to be economically equivalent to the debt it is replacing.³¹¹ Yet the preferred equity payments would generate the same tax consequences as would uncapped debt payments.

Moreover, corporate taxpayers can also play this game, although additional steps are needed for them. Were a corporate taxpayer to try the same maneuver directly, that corporate taxpayer would receive no tax benefit, because dividends are not deductible to corporate taxpayers.³¹² Thus, corporate taxpayers

310. This attorney wishes to remain anonymous, so as to facilitate alerting policymakers and the public to this game, while still advising clients on how to take advantage of the game. *See id.*

311. As the attorney elaborates,

the preferred equity would not have an identical credit profile to the subordinated debt it replaced. However, for many businesses, that profile would be similar, or similar enough that the tax benefit would exceed the marginal cost of financing using preferred equity rather than debt. Businesses could also engage in structuring to enhance the credit profile of the preferred equity—for example, by carving off a particularly low-risk business line into a partnership subsidiary and issuing the preferred equity out of that subsidiary (without an upstream guarantee). In other words, issuers would retain wide flexibility to structure the credit profile of their financing in an optimal manner.

Id.

312. This is in contrast to profit shares paid out by a partnership, which will now, under the new rules of the tax legislation, be taxed preferentially relative to potentially capped debt financing. This is because profit shares paid out are essentially deductible to the partnership, and only taxed once at the individual level, due to the absence of an entity level “double” tax on partnership income like there is for corporate income. Further exacerbating this differential tax treatment, investors who hold preferred equity-like interests in partnerships

would need to establish a partnership subsidiary that would then issue the preferred equity used to pay off the capped portion of the prior debt financing. As the same attorney elaborates:

If the business were a corporation, similar planning would be available. The corporation could drop its operations into a partnership subsidiary (likely achievable as a reorganization without the burden of actually transferring assets, etc.), and the partnership subsidiary could issue the preferred equity. If the debt remained at the parent corp level, the partnership sub could provide an upstream guarantee to avoid potential structural subordination of the senior debt.³¹³

The primary obstacle for either partnership or corporate taxpayers wishing to play this game, then, is to find a counterparty willing to fund the preferred debt that is to be used to pay off the capped portion of the prior debt financing. This should not be especially difficult for well-advised taxpayers to arrange. Indeed, the tax legislation effectively subsidizes counterparties willing to fund these sorts of swapping-preferred-equity-for-debt-financing games, due to the new pass-through deduction. The same attorney again elaborates:

It seems there are some additional goodies, amounting to an apparent tax subsidy for the finance provider in this structure. Consider a high net worth US individual (or a partnership of multiple high net worth individuals) being the new preferred equity partner. These new preferred equity partners would earn \$10 ordinary income from their partnership interest, generally taxed at the same rate as interest income. However, it appears they could also qualify for [the new 20% pass-through deduction] on this income

. . . .

. . . So, historic equity holders retain the benefit of \$40 of deductible financing expense, while the finance provider receives a subsidy in the form of a 20% deduction for participating in the preferred equity structure versus an investment in debt.³¹⁴

Altogether, then, at least for sophisticated and well-advised taxpayers who are able to put together the necessary financing arrangements, the tax legislation's crucial new interest expense limitation can readily be gamed around. But could the IRS take action to prevent this game?

In theory, Treasury and the IRS might attempt to use their broad powers under section 385(a) of the Internal Revenue Code to "prescribe such regulations as may be necessary or appropriate to determine whether an interest in a corporation is to be treated . . . as stock or indebtedness."³¹⁵ However, those section

potentially would be eligible for the new 20% pass-through deduction. *Id.*

313. *Id.*

314. *Id.*

315. I.R.C. § 285(a) (2017).

385 powers would seem not to apply in cases where a subsidiary partnership of the corporation (rather than the corporation itself) issues debt-like preferred equity.

Alternatively, the IRS might try to attack this game by re-characterizing partnership-preferred equity as debt under section 707(c), which applies to guaranteed payments by a partnership.³¹⁶ However, as the provision is currently codified, section 707(c) applies only for the purposes of specific code sections and subsections, and does not apply to the new cap on interest deductions under section 163(j).³¹⁷

Overall, new legislation will probably be needed in order to combat this game so as to meaningfully enforce the new cap on interest expense deductions.

2. Circumventing the Limitations on Deducting Executive Compensation

Above, we explained how a corporate taxpayer could establish a pass-through subsidiary in order to circumvent the new interest expense limitation. But this is not the only game that can be played by stacking corporate and partnership structures into stacks of entities so as to arbitrage the different rules that apply to corporations and to partnerships.

Another game that can be played by stacking a corporation on top of a pass-through entity (sometimes called an Up-C structure³¹⁸) would circumvent the new limitations on deducting executive compensation. Specifically, the tax legislation amended section 162(m) to further limit public (and certain private) companies' ability to deduct salaries paid in excess of \$1 million.

The game here is to transform highly paid executives (whose compensation would otherwise be subject to this new limit) into partners of a partnership subsidiary of the corporation.³¹⁹ These executives would then be paid portions of their compensation in the form of allocations of income via the partnership.³²⁰ Because these allocations would not be considered salary or wages, this

316. *Id.* § 707(c).

317. *Id.*

318. For more on this, see David Miller, *Tax Planning Under the Tax Cut and Jobs Act: Flow Throughs Are the Answer to Everything 2* (2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3070662.

319. *Id.*

320. *Id.*

structure would circumvent the new section 162(m) limitations.³²¹

B. MISCELLANEOUS ITEMIZED DEDUCTION GLITCHES

The tax legislation completely suspends miscellaneous itemized deductions for tax years 2018 through 2025.³²² Miscellaneous itemized deductions were already heavily restricted under prior law, which resulted in hardship for a number of taxpayers.³²³ Yet, despite those prior limitations, miscellaneous itemized deductions previously provided important—and appropriate—write offs for some taxpayers. Those write offs are now completely denied.

Consider the tax treatment of contingency fees for lawyers in legal settlements in cases involving issues like defamation, intentional infliction of emotional damage, and punitive damages. Under both prior and current law, plaintiffs must generally include the entire amount of damage awards in the plaintiffs' income, even though a portion of that damage award (typically 40%) must usually be paid to the plaintiff's attorney.³²⁴ Under prior law, the plaintiff could then deduct the amount paid to the attorney for the contingency fee as a miscellaneous itemized deduction. But now, with miscellaneous itemized deductions no longer available, these plaintiffs will no longer be able to deduct any portion of the contingency amounts paid to plaintiffs' attorneys (even as the lawyer is also taxed on the contingency fee being paid).

To illustrate, consider a plaintiff receiving a \$10,000 damage award, of which 40% is owed to the plaintiff's attorney as contingency. Imagine that the plaintiff is in the top 37% individual income tax bracket. After paying both the contingency fee (of \$4,000) and the federal individual income tax payment on the

321. *Id.*

322. I.R.C. § 67(g).

323. For instance, many artists were effectively taxed at excessively high effective rates on account of their being denied deductions for expenses that were necessary for them to earn their income. See Amy Sohn, *How the Tax Code Hurts Artists*, N.Y. TIMES, April 1, 2015, at A23.

324. Robert W. Wood, *10 Things To Know About Taxes On Legal Settlements*, FORBES (July 6, 2015), <https://www.forbes.com/sites/robertwood/2015/07/06/10-things-to-know-about-taxes-on-legal-settlements> (“If you are the plaintiff and use a contingent fee lawyer, you’ll usually be treated (for tax purposes) as receiving 100% of the money recovered by you and your attorney, even if the defendant pays your lawyer directly his 30% to 40% contingent fee cut.”).

entire damage award (of \$3,700), the plaintiff would be left with only \$2300 of the damage award (\$10,000 – \$7,700).

Now consider that the plaintiff may also need to pay state and local taxes on the entire \$10,000 damage award and that the plaintiff may further need to compensate the attorney for expenses incurred (with this payment also being non-deductible). In some scenarios, adding these additional payments could cause a plaintiff to lose money as a result of needing to pay a damage award. For instance, Gregg Polsky has explained a scenario in which a plaintiff could receive a \$500,000 jury award, but then consequently be required to pay \$300,000 to the plaintiff's attorney and \$250,000 in combined federal and state and local taxes.³²⁵ Thus, this plaintiff would be made \$50,000 worse off on account of winning the jury award.

Although Polsky's example involves more extreme hardship than will typically be the case, many similarly situated taxpayers will take home only a small percentage of damage awards received after paying taxes and attorney's fees. Indeed, some taxpayers will indeed be made overall worse off from receiving a damage award, as in Polsky's scenario. This demonstrates the unwarranted hardship created by completely denying miscellaneous itemized deductions for all taxpayers—another glitch that should be fixed.

CONCLUSION

In this Article, we explain many of the most problematic games, roadblocks, and glitches created by the 2017 tax legislation. However, we emphasize again that the new tax legislation contains many other technical problems beyond those that we discuss here. Indeed, tax lawyers and accountants continue to discover new games, roadblocks, and glitches as they ponder the application of the new provisions to the facts and circumstances of their taxpayer clients.³²⁶

325. Gregg Polsky, *The Libel Tax*, SLATE (Jan. 4, 2018), <https://slate.com/news-and-politics/2018/01/the-gops-new-law-taxes-people-for-winning-defamation-claims.html>.

326. To list just one example, commentators have recently discovered troubling games and glitches related to unwarranted tax benefits obtainable by farming businesses that sell to cooperatives. See Scott Greenberg, *The 'Grain Glitch' Needs to Be Fixed*, TAX FOUND. (Feb. 8, 2018), <https://taxfoundation.org/grain-glitch-needs-fixed>. The grain glitch was addressed in later legislation, Richard Rubin, *Congress Reaches Deal to Fix Tax Overhaul's 'Grain Glitch'*, WALL ST. J. (Mar. 21, 2018), <https://www.wsj.com/articles/congress-reaches>

The question now should be: *Where do we go from here?* Diagnosing the problems plaguing our new tax laws ought to be a precursor to working toward solutions.

Some of the problems we explained can and should be solved through relatively minor legislative or regulatory fixes. But many of the problems that we identify do not have easy solutions. A thorough deliberative process will thus be needed to ensure that future attempts at tax reform do not repeat the mistakes of this recent tax legislation.

We hope that this Article will initiate discussions about potential approaches for future reform. So as to not repeat the mistakes of the past, we must aim to learn from this recent historical episode, wherein a rushed and secretive process resulted in deeply flawed tax legislation. Future revenue needs are predicted to be dire,³²⁷ and American taxpayers deserve better.

-deal-to-fix-tax-overhauls-grain-glitch-1521649599, but many other problems surely remain and continue to be discovered.

327. *Sizing Up Revenue With the Tax Bill Enacted*, COMMITTEE FOR RESPONSIBLE FED. BUDGET (Jan. 5, 2018), <http://www.crfb.org/blogs/sizing-revenue-tax-bill-enacted> (“Solving the nation’s fiscal challenges was difficult before the tax bill was enacted, and it has only gotten even more challenging.”).